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THE DEPARTMENT OF LABOR'S ENFORCEMENT OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)

A REPORT

PREPARED BY THE

SUBCOMMITTEE ON OVERSIGHT OF
GOVERNMENT MANAGEMENT

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
SUBCOMMITTEE ON OVERSIGHT
OF GOVERNMENT MANAGEMENT,
Washington, DC, April 2, 1986.

Hon. WILLIAM V. ROTH, Jr.,
Chairman, Committee on Governmental Affairs,
Washington, DC.

DEAR MR. CHAIRMAN: The Subcommittee on Oversight of Government Management transmits the following report on "The Department of Labor's Enforcement of ERISA."

During the past year, the Oversight Subcommittee has investigated the Department of Labor's enforcement of the provisions of the Employee Retirement Income Security Act (ERISA) governing private pension plans, with particular attention to the fiduciary duty established by the law. Under ERISA, individuals who make decisions affecting pension plan assets must act solely in the interests of the plan's participants and beneficiaries.

The Subcommittee's investigation included two days of public hearings in June of 1985, at which Labor Department officials, three former administrators of the Department's Office of Pension and Welfare Benefit Programs, and private sector witnesses testified.

The Subcommittee found that the Department of Labor is overwhelmed by its responsibilities under ERISA. Inadequate resources, conflicting priorities, and rapid turnover in the leadership positions have hampered the ability of the Department to enforce this complex law.

At a time when ERISA fiduciaries have become major players in high stakes mergers and acquisitions, the Department faces significant challenges in interpreting and enforcing the law in the context of contests for corporate control. While the Department has undertaken effective enforcement actions to protect against the misuse of pension assets in some cases, the Department generally has failed to provide adequate guidance to pension plan fiduciaries on questions of corporate governance. To remedy this problem, the Subcommittee has recommended that the Department issue a detailed policy statement addressing the obligations of fiduciaries in voting stock and in considering tender offers.

Most disturbing to the Subcommittee is the evidence that some voting and investment decisions involving ERISA funds are tainted by conflicts of interest. The Subcommittee believes that this issue deserves further investigation and has recommended that your Permanent Subcommittee on Investigations, with its considerable investigative resources, pursue these allegations.

The Subcommittee's report also contains several other recommendations to the Department of Labor, including proposals to improve its ability to detect violations of ERISA by pension plan fiduciaries, to process requests for prohibited transaction exemptions, and to handle the annual reports filed by pension plans more efficiently.

All of the players in the ERISA system—the Department of Labor, plan sponsors, investment managers, and others—need to be more active to ensure the integrity of pension funds. More than 64 million American workers are counting on private pension funds for their retirement income. Their retirement security is dependent on decisions made each day in the marketplace by ERISA fiduciaries. Vigorous implementation of the recommendations in this report, as well as continued debate and oversight, will help to fulfill the promise of ERISA to American workers.

Sincerely,

WILLIAM S. COHEN, *Chairman.*

CONTENTS

	Page
Letter of Transmittal	III
I. Introduction	1
II. Summary	4
III. Background	9
IV. Traditional Enforcement Issues	15
V. Pension Funds and Corporate Governance	43
VI. Conclusion	69
VII. Chart: Private Pension Plan Assets 1975–1985	71

THE DEPARTMENT OF LABOR'S ENFORCEMENT OF ERISA

I. INTRODUCTION

Over the past year, the Senate Subcommittee on Oversight of Government Management has conducted an investigation of the Department of Labor's implementation of its responsibilities under the Employee Retirement Income Security Act of 1974, better known as ERISA.

In 1974, the Congress charged the Department of Labor, along with the Department of the Treasury and the newly created Pension Benefit Guaranty Corporation, with the responsibility to oversee and enforce this historic piece of legislation that was designed to protect the pension and welfare benefit rights of workers and their beneficiaries.

The focus of the Subcommittee's review was the performance of the Department of Labor's Office of Pension and Welfare Benefit Programs (OPWBP) in administering the provisions of ERISA governing pension plans. The importance of the Department's administration of ERISA becomes immediately clear upon even a brief recital of the pension plan universe. According to Department of Labor statistics, there were 788,452 private pension plans in 1984; 745,088 of these plans had fewer than 100 participants. The large majority of these plans—785,335 in 1984—were single employer plans, while 3,117 of the plans were multiemployer plans. In 1984, these private pension plans covered 64.5 million workers.

The number of individuals currently receiving retirement benefits under private pension plans is also significant. According to the Employee Benefit Research Institute, approximately 8.7 million persons were receiving retirement benefits in 1984. With so many pensioners, both current and future, dependent on the protections established by ERISA, it is crucial that the Congress ensure that the Department of Labor is adequately overseeing and enforcing the law.

Acting on its mandate to "oversee the efficiency and economy of government operations," the Subcommittee undertook an investigation of the OPWBP to determine how well it has performed its statutory functions

The Subcommittee was concerned by the findings of many entities, both within and outside the Department of Labor, that the OPWBP's enforcement of ERISA has been deficient in several areas and should be improved. Some problem areas cited in these reports included the Department's procedures for detecting violations of ERISA by pension plans and their fiduciaries, the information reporting and processing within the OPWBP, and the processing of prohibited transactions exemption applications.

The Subcommittee also examined the relationship of the fiduciary duties set forth in ERISA to questions of corporate governance.

A major element of ERISA is the duty it imposes on fiduciaries of pension and employee benefit plans to act solely in the interest of plan participants and beneficiaries. While this fiduciary rule is as old as ERISA itself, several recent factors have sparked renewed interest in the meaning of this rule in the context of corporate governance issues.

First, the phenomenal growth of pension fund assets, which, according to Department of Labor statistics, exceeded one trillion dollars in 1984, and the emergence of pension funds as influential institutional investors have raised increasing questions about what responsibilities ERISA imposes on plan fiduciaries in making such decisions as how to vote stock and whether to accept tender offers for shares held by pension funds.

Second, the highly publicized wave of mergers and takeovers, many involving corporations in which private pension funds are significant shareholders, has raised the fundamental issue of how active the fiduciaries of pension funds must be as shareholders in order to fulfill their legal obligations. Another recent concern has focused on the abuse of using pension funds to finance, or defend against, corporate takeovers.

Finally, there have been growing reports that conflicts of interest may be influencing the decisions of some pension fund managers and other plan fiduciaries, raising questions about whether the best interests of the plan's workers and beneficiaries are always being served. Some observers have suggested that other considerations, such as cultivating good relationships with existing or potential clients, are at times placed ahead of the best interests of plan participants and beneficiaries.

The Subcommittee believed that these concerns, as well as Department of Labor's response to these trends, deserved attention. On July 25 and 26, 1985, the Subcommittee held oversight hearings on these issues. On the first day of the hearings, three former Administrators of the Office of Pension and Welfare Benefit Programs—Robert A.G. Monks, OPWBP Administrator in 1984, Jeffrey N. Clayton, OPWBP Administrator from 1981–83, and Ian D. Lanoff, OPWBP Administrator from 1977–81—testified before the Subcommittee. Janet Brown, former Special Assistant to the OPWBP Administrator, accompanied Mr. Monks. The Subcommittee also heard testimony from Michael S. Gordon, an attorney in private practice specializing in ERISA and employee benefits law. Mr. Gordon served as Minority Counsel for Pensions for the Senate Committee on Labor and Public Welfare from 1970–75, the period during which ERISA was drafted.

On July 26, the Subcommittee heard testimony from Francis X. Lilly, Solicitor of the Department of Labor, and Alan D. Lebowitz, the Acting OPWBP Administrator; Dean LeBaron, President, Batterymarch Financial Management; George W. Cowles, Senior Vice President, Bankers Trust Company, representing the Association of Private Pension and Welfare Plans; and James Heard, Deputy Director, Investor Responsibility Research Center, Inc., who was accompanied by Hillel Gray.

The testimony presented at these hearings, as well as other information and evidence gathered during the course of the Subcommittee's investigation, provides the basis for the findings and recommendations set forth in this report.

II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

The Oversight of Government Management Subcommittee has reviewed the Department of Labor's enforcement of the provisions of the Employee Retirement Income Security Act (ERISA) governing private pension plans, with emphasis on the fiduciary duty established by the law. The Subcommittee's investigation included two days of public hearings in June of 1985, at which Labor Department officials, three former administrators of the Department's Office of Pension and Welfare Benefit Programs, and private sector witnesses testified.

A. TRADITIONAL ENFORCEMENT ISSUES

1. FINDINGS

a. Despite the millions of workers and retirees dependent on ERISA-covered pensions, as well as the huge monetary stakes involved, the Subcommittee found that enforcement of ERISA has not been a high priority of the Federal Government. Rather, the Department of Labor's implementation of the law has been characterized by grossly inadequate resources, longstanding deficiencies, frequently changing and inconsistent leadership, and shifting enforcement strategies.

b. With less than one percent of pension plans being audited each year by the Department of Labor, the chances of the Department detecting violations of ERISA are minuscule. The lack of meaningful oversight of pension plans and their fiduciaries could jeopardize the pension protections established by ERISA.

c. The Department of Labor has changed its enforcement strategy repeatedly over the past 11 years, resulting in fragmented enforcement efforts to detect violations of ERISA. Inadequate training of OPWBP employees has exacerbated this problem.

d. The Department of Labor is far behind in processing the information reported annually by private pension plans. As a result, the information available to the Department's auditors and investigators is often out-of-date and incomplete.

e. The Department's process for reviewing prohibited transaction exemption requests is too slow and may result in lost investment opportunities for pension plans. Furthermore, the Department fails to follow up on its referrals to the Internal Revenue Service for imposition of an excise tax on parties who engage in prohibited transactions. The IRS closes the files on many of the DoL's referrals without imposing an excise tax, raising serious questions about how well the referral agreement between the DoL and the IRS is working.

2. RECOMMENDATIONS

a. The OPWBP should be given a line item in the Department of Labor's budget to facilitate congressional scrutiny of the resources allocated to enforcement of ERISA.

b. The Department of Labor should establish a long-term enforcement strategy and should promptly develop a computer-assisted targeting program to identify pension plans for audit and investigation.

c. The Secretary of Labor should grant Schedule A hiring authority for attorneys within the OPWBP to increase the expertise available to the Office. In addition, comprehensive training should be provided to OPWBP investigators and auditors.

d. To alleviate its problems in using the information from plan sponsors, the Department should pursue electronic filing of the annual reports (5500 forms) required by the statute.

e. The Department should revise the 5500 series annual reports to enable the DoL to use them more effectively for enforcement purposes. Specifically, the OPWBP should conduct a study to correlate the information reported on these reports with detected violations of ERISA.

f. To improve the processing of applications for prohibited transaction exemptions, the Department should:

—increase its use of the ERISA Advisory Council as an important source of private sector expertise for analyzing proposed transactions that are subject to the prohibited transaction rules;

—seek more inter-agency coordination in order to obtain the assistance of other Federal agencies in analyzing proposed prohibited transactions; and

—place more emphasis on the class exemptions, prototype transactions, and clearer definitions of statutory exemptions as a means of expediting the prohibited transaction process.

The Subcommittee opposes two other suggestions for solving the prohibited transactions problems: the Department of Labor's proposal for a self-regulatory organization (SRO), and a proposed amendment to ERISA to change the prohibited transaction rules to an "arms length, adequate consideration" standard.

g. The Department of Labor should establish formal follow-up procedures for cases of probable ERISA violations that are referred to the Internal Revenue Service and the Department of Justice for action.

B. Pension Funds and Corporate Governance

1. FINDINGS

a. Pension funds held more than $1 trillion in assets in 1984. A major portion of these assets, more than $400 billion, was invested in corporate stock. Private pension funds now own approximately one-fifth of the stock of publicly traded corporations, a proportion that may exceed 50 per cent by the year 2000. As a result of these large stockholdings, private pension plans can exert considerable influence on the market and have an important role to play in corporate governance issues.

b. The Department of Labor has failed to provide adequate guidance to pension plan fiduciaries on questions of corporate governance.

c. While ERISA permits plans sponsors to delegate voting authority to outsider managers, the Subcommittee finds that such delegation, which is the customary practice, can create conflict of interests in some cases.

d. The Subcommittee believes that ERISA fiduciaries have an obligation to evaluate carefully those corporate governance issues which can affect the rights of shareholders and the value of their investments and to vote the stock according to the best interests of the plan participants and beneficiaries. Specifically, the Subcommittee finds that an ERISA fiduciary who has the power to vote stock has a legal obligation to exercise this authority when questions that may affect the value of the shares come before him. To fail to vote, to cast a vote without considering the impact of the question, or to vote blindly with management would appear to violate the mandate of ERISA that the fiduciary must act for the exclusive benefit of the plan's participants and beneficiaries.

e. The Subcommittee finds that the weight of the evidence suggests that antitakeover charter amendments often are contrary to the interests of shareholders. Although certain pension fund fiduciaries have been in the vanguard of shareholders who have questioned the impact of such charter amendments, almost all of the antitakeover amendments proposed during the past year were approved by wide margins even in corporations widely held by institutional investors. The passage of these amendments raises the question of whether or not ERISA fiduciaries are fulfilling their legal obligations to make decisions solely in the best interests of plans' beneficiaries and participants.

f. Based on its hearings, interviews, and research, the Subcommittee believes that some ERISA fiduciaries are not complying with the "exclusive benefit" mandate of the law. While ERISA fiduciaries, as a group, have been reluctant to acknowledge conflicts of interest and pressure, the evidence strongly indicates that some fiduciaries are making voting decisions in pursuit of their own economic interests, typically in response to outside pressure or motivated by a desire not to offend existing or potential clients.

g. The use of pension funds assets by plan sponsors to defend against or assist in a hostile takeover attempt poses a serious threat to the integrity of private pension plans. To guard against the misuse of plan assets in a contest for corporate control involving the plan's sponsoring company, the Subcommittee finds that plans should be insulated so that decisions involving the use of plan assets are made solely on behalf of the participants and beneficiaries and independently of the interests or goals of plan sponsors. The Subcommittee commends the Department of Labor for the enforcement actions it has undertaken to protect against the misuse of pension fund assets.

h. The Subcommittee finds that there is considerable confusion about the obligations of fiduciaries in responding to tender offers. In the Subcommittee's view, a pension fiduciary does *not* have a legal obligation invariably to accept the highest bid, regardless of the individual circumstances of a tender offer.

2. RECOMMENDATIONS

a. The Subcommittee recommends that the Department of Labor take immediate steps to formulate and issue a policy statement specifying the responsibilities of fiduciaries in confronting questions of corporate governance. The policy statement should address the obligations of fiduciaries to vote the stock held in pension fund portfolios, discuss the duty of fiduciaries in voting on antitakeover charter amendments, and clarify the responsibility of fiduciaries in responding to tender offers.

b. The Department of Labor should work more closely with the private sector to enhance understanding of fiduciary obligations. Issuing a policy statement on corporate governance issues would provide needed guidance to plan sponsors, trustees, and investment managers, underscore the importance of careful attention to corporate governance issues, and promote compliance with ERISA's fiduciary standards.

c. The issue of delegating voting responsibility for the shares held by a pension fund deserves more attention from both plan sponsors and the Department of Labor. Plan sponsors who delegate such decisions to outside managers should monitor closely how voting decisions are made to ensure that they are not tainted by conflicts of interest. Plan sponsors may want to consider retaining voting responsibility for the shares in the plan's portfolio. The Department of Labor should initiate its own review of the delegation issue to determine whether or not plan sponsors are in a better position than outside managers to exercise voting responsibilities and to resolve conflict-of-interest problems.

d. The Labor Department should encourage plan sponsors and financial intermediaries to establish voting policies and procedures to ensure that potential conflicts of interest are resolved in favor of plan beneficiaries. The Subcommittee further recommends that the Department consider requiring public disclosure of voting policies and procedures, as well as the actual votes cast by fiduciaries. In the Subcommittee's judgment, the sunshine of disclosure would go a long way toward eliminating abuses and would facilitate the DoL's enforcement efforts.

e. To facilitate a study of voting delegation, policies and other issues, the Department of Labor should conduct a survey of ERISA fiduciaries, including plan sponsors, trustees, and investment managers to obtain information on the policies and practices of pension funds concerning corporate governance issues.

f. The Subcommittee recommends that when fiduciaries face conflicts of interest because of their relationship to plan sponsors, the investment and voting decisions affecting pension assets should be placed in the hands of independent fiduciaries. The Subcommittee will work with the Department of Labor to develop legislation to strengthen ERISA in this area.

g. The Subcommittee believes that further investigation of the conflict of interest allegations involving some ERISA fiduciaries is warranted. The Subcommittee, therefore, is referring this matter and the documentation obtained by the Subcommittee to the Senate Governmental Affairs Permanent Subcommittee on Investigations with a recommendation that PSI conduct an in-depth investigation to determine the validity of the allegations and the extent to which such abuses are occurring.

III. BACKGROUND

A. Overview of ERISA

The Employee Retirement Income Security Act (ERISA) was signed into law by President Ford on Labor Day, September 2, 1974. Designed to protect the pension and welfare benefit rights of workers and their beneficiaries, this landmark legislation was the most comprehensive employee benefits law ever enacted in the United States and an acknowledgement of the growing importance of private pensions to the retirement security of millions of American workers and their families.

The enactment of ERISA was the culmination of a long history of events which laid the foundation for imposing comprehensive federal regulatory standards on employee benefit plans. The failure of the Welfare and Pension Plan Disclosure Act of 1958 to adequately deter abuses in the handling of employee benefit funds, tragic pension plan failures such as the highly publicized 1963 Studebaker case in which over 4,000 workers lost virtually all of their vested pension benefits when the plan terminated, and the 1965 report of the Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, a cabinet-level committee created by President Kennedy, were all factors which led to Congress' decision to address the inequities in the private pension system.

ERISA was the result of over a decade of debate on the substance and scope of the pension reforms that should be enacted. The final product represented "an effort to strike the appropriate balance between the interests of employers and labor organizations in maintaining flexibility in the design and operation of their pension programs, and the need of the workers for a level of protection which adequately protects their rights and just expectations." [1] Congress sought to maintain the voluntary growth and development of private pension plans, while at the same time assuring "American workers that they may look forward with anticipation to retirement with financial security and dignity, and without fear that this period of life will be lacking in the necessities to sustain them as human beings in our society." [2]

ERISA sought to establish a coordinated approach to safeguarding the interests and rights of pension plan participants and beneficiaries in the following ways:

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[1] "The Employee Retirement Income Security Act of 1974: The First Decade, An Information Paper prepared for use by the Senate Special Committee on Aging, Senate Report 98-221, 98th Congress, 2nd Session, August 1984 (From Chapter 1, "Overview: Why Was ERISA Enacted?", Michael S. Gordon, p. 22).

[2] Id., p. 23.

To address the abuses and unsound practices that jeopardized the security of pension plan assets and threatened the availability of funds for participants, ERISA established a uniform federal standard of fiduciary responsibilities in the administration and operation of pension plans and plan assets.

To ensure that pension plans have sufficient assets to pay promised benefits when participants retire, ERISA set forth minimum funding standards.

To eliminate the unreasonable age and service requirements which deny benefits to participants despite long years of employment and to increase benefit eligibility, ERISA required plans to meet certain eligibility, participation, and vesting rules.

To ensure that participants are aware of pension rights and obligations, and to facilitate the enforcement of the new funding and fiduciary standards, ERISA established extensive reporting and disclosure requirements.

And, finally, to ensure the payment of promised benefits in the event of plans terminating without sufficient assets, ERISA created a pension plan termination insurance program.

B. Organizational Structure

ERISA is composed of four titles. Title I, dealing with the protection of employee benefit rights, is administered by the Department of Labor. Title II, administered by the Department of the Treasury sets forth the participation, vesting, funding, and other tax qualification requirements for pension and employer benefit plans. Title III deals with the division of responsibility between the agencies administering the law, and Title IV establishes the Pension Benefit Guaranty Corporation (PBGC) and the plan termination insurance program.

The administrative and enforcement apparatus established by Congress to implement ERISA reflected not only the Congress' internal jurisdictional disputes but a broader lack of consensus on the appropriate jurisdictional sphere for private pension issues. The result was a system of overlapping jurisdiction with the responsibilities divided among the Department of the Treasury, the Department of Labor, and the newly created PBGC.

ERISA created an unusual system of dual jurisdiction between the Department of Labor and the Department of the Treasury. This dual jurisdiction resulted primarily from the inclusion in both Title I, the DoL section, and in Title II, the IRS section, of virtually identifical provisions dealing with participation and vesting, funding, fiduciary responsibilities, and prohibited transactions.

In certain instances, ERISA gave both the Department of Labor and the Department of the Treasury joint regulatory authority over the same provisions of the law. In other instances, although one agency was given primary jurisdiction, it was required to coordinate its actions with the other department before proceeding.

The cumbersome administrative structure necessitated by this overlapping jurisdiction threatened the successful implementation of ERISA, an already difficult task given the complexity and technical nature of the law. The result of this structure was "overlap and duplication of efforts by the agencies, as well as delay, confusion, and burdensome reporting requirements for plan managers and unions." [3] Delays in issuing regulations and in the processing of exemptions from the prohibited transaction rules were the most serious problems created.

Effective in 1978, the President's Reorganization Plan No. 4 sought to eliminate most areas of dual jurisdiction through a clear division of responsibility between the Departments of Treasury and Labor and, therefore, to make the administration of ERISA simpler and more efficient. The primary changes made by the Reorganization Plan were to transfer authority over minimum standards in participation, vesting and funding to Treasury and to transfer authority over fiduciary obligations and prohibited transactions to the Department of Labor.

Although most of the responsibilities for administering ERISA were divided between the two agencies, both retained authority over enforcement efforts, requiring continued coordination and cooperation in this area to avoid duplicative investigations of plans in possible violation of the law. In addition, although the Reorganization Plan assigned to one agency the responsibility for each of the major provisions of the Act, the transfer was subject to a few qualifications requiring the concurrence of one agency in certain proposed actions taken by the other.

C. RESPONSIBILITIES OF THE DEPARTMENT OF LABOR

The Department of Labor has responsibility for the investigation and enforcement of violations of Title I, which encompasses the reporting and disclosure, participation and vesting, funding, and fiduciary responsibility provisions. The Department has primary responsibility for the administration of the fiduciary standards for responsible plan administration and the rules for the reporting and disclosure of plan provisions and financial activities. Under the Reorganization Plan, the Treasury Department transferred to the Department of Labor the authority to issue regulations, rulings, and opinions with regard to the reporting and disclosure rules and fiduciary standards, including the prohibited transaction provisions. This transfer of authority does not affect the Department of the Treasury's authority to enforce excise tax penalties for violations of the prohibited transaction rules.

1. REPORTING AND DISCLOSURE

Under ERISA, pension and welfare plans must disclose to participants and report to the federal government information about plan provisions and financial status. The extensive reporting and disclosure requirements are rooted in the belief that public disclosure of plan information will promote compliance with the law and, specifically, that opening the financial transactions of plan fiduciaries to public scrutiny will deter fiduciaries from engaging in transactions prohibited by the Act. The reporting and disclosure requirements serve a dual purpose. Providing participants with information about the plan increases awareness of their rights and obligations and what benefits they can realistically expect to receive. In addition, reporting to the government is essential to monitoring compliance with the Act's mandates.

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[3] House Committee on Government Operations. Reorganization Plan Number 4 (ERISA Administration); Report to accompany H. Res. 1308, 95th Congress, 2nd Session, Washington, U.S. Government Printing Office, 1978.

Plan descriptions, summary plan descriptions, and annual reports are among the reports that plans must file with the Department of Labor. The Department is responsible for making sure that certain plan disclosures are made by plans to participants. Other reports must be filed with the Department when certain events occur. All of the reports are designed to assist the government in ensuring that plans are operated in compliance with the law and that participants' rights are protected.

The basic reporting document is the annual report (5500 report) which contains detailed financial information, including plan assets and liabilities, a statement of the transactions involving parties-in-interest, and other information regarding investment of plan assets and administration of the plan. In 1977, to reduce the paperwork burden on plans, the form for the annual report to the Labor Department was consolidated with the form for the report to the Internal Revenue Service. The annual report is now filed only with the IRS which then furnishes the information to the Department of Labor. Additionally, some information from the report is sent to the Pension Benefit Guaranty Corporation.

The basic disclosure document, which must be furnished to participants as well as to the Department of Labor, is a Summary Plan Description (SPD). The SPD must be written in a manner calculated to be understood by the average person and must contain a description of benefits, the requirements for eligibility, and procedures for presenting claims for benefits.

2. FIDUCIARY RESPONSIBILITIES AND PROHIBITED TRANSACTIONS

The general requirements imposed by ERISA on all plan fiduciaries are administered and enforced by the Department of Labor and apply to all employee benefit plans. ERISA requires fiduciaries to discharge their duties with respect to a plan solely in the interest of and for the exclusive purpose of providing benefits to the plan participants and beneficiaries, and to act prudently with respect to the assets under their trust. The Act also requires plan fiduciaries to diversify plan assets when it is prudent to do so and to abide by the provisions of the documents that establish the plan, insofar as those provisions are consistent with ERISA.

Certain transactions between plans and persons with conflicting self interests (called "parties-in-interest") are prohibited by ERISA unless specifically exempted by the Act itself, or by the Department of Labor. As mandated by the Act, the Department of Labor has established procedures for allowing exemptions from the prohibited transaction rules for which there are no statutory exemptions. Exemptions are not allowed unless the transaction is in the best interest of the plan and its participants, does not present administrative problems, and provides adequate safeguards to protect the interests of participants and beneficiaries. The exemptions granted by the Department may be conditional or unconditional and may exempt a transaction from all or part of the prohibited transaction rules. In addition, exemptions may be for a particular transaction or for a class of transactions. An exemption has no effect on the basic fiduciary responsibility rules.

3. PLAN MINIMUM STANDARDS

The participation, vesting and funding rules contained in Title I are similar in most respects to the participation, vesting and funding provisions under the tax provisions of Title II. The Title I provisions apply to all employee benefit plans, regardless of whether the plans qualify for preferred tax treatment, but the primary responsibility for administering the participation, vesting and funding rules for tax-qualified plans is assigned to the Department of the Treasury. Although the 1978 Reorganization Plan transferred overall authority to issue rules and regulations with respect to plan minimum standards (standards for funding, participation and vesting of benefits) to the Department of the Treasury, the Department of Labor retains its enforcement responsibilities for these provisions.

4. ENFORCEMENT AUTHORITY

The Department of Labor has broad enforcement responsibility under ERISA and plays the principal role in fiduciary enforcement for all plans, including the prohibited transaction area where the imposition of an excise tax by the IRS is also an important enforcement mechanism. The Department's enforcement authority extends to both civil and criminal matters under Title I of the statute, although litigating authority is for civil enforcement only. The Attorney General is responsible for criminal prosecutions.

Under the statute, the Labor Department is given broad investigatory power to determine whether a violation has or is about to occur under Title I, and broad civil litigation authority to secure compliance with any provision of Title I or any regulation made under it. The Department may sue to enjoin acts or practices which violate provisions of Title I or to obtain any other appropriate relief to enforce the rules. In addition, the DoL may file suits to secure compliance by employee benefit plans under certain other circumstances.

In enforcing the fiduciary rules, the Labor Department may sue a fiduciary to make restitution to the plan for any losses resulting from a breach of fiduciary duty, including the improper handling of plan assets, and to obtain an injunction to prevent a future breach of fiduciary duty. In addition, the Department may being a suit to obtain restitution from a non-fiduciary who participated in a breach of fiduciary duty against a plan. The Department has the same powers to conduct plan investigations and issue subpoenas with regard to enforcing the fiduciary responsibility rules as it has for enforcing the reporting and disclosure, participation, vesting, and funding rules. The Department of the Treasury's authority to impose excise tax penalties on plans qualifying for favorable tax treatment (tax qualified plans) for violations of the prohibited transaction rules is mirrored in the authority given to the Department of Labor to impose civil penalties on non-tax-qualified plans for prohibited transactions.

IV. TRADITIONAL ENFORCEMENT ISSUES

A. Inadequate Priority of the Department of Labor

Despite the millions of workers and retirees dependent on ERISA-covered pensions and the huge monetary stakes involved, the Subcommittee found that the ERISA program has not been a high priority of the federal government. Rather, the history of the ERISA program has been characterized by inadequate resources, longstanding deficiencies, frequently changing and inconsistent leadership, and shifting enforcement strategies.

A major problem that has plagued the ERISA program within the Department of Labor has been inadequate resources throughout its 11-year history. The Subcommittee found it particularly noteworthy that all three former Administrators of the OPWBP described the ERISA program as suffering from grossly inadequate resources. Robert A.G. Monks, who served as OPWBP Administrator from January 1984 to January 1985, for example, testified that "there is no question that during my tenure at the Department there were not sufficient resources to administer the law effectively." [4] Similarly, OPWBP Administrator Jeffrey Clayton, who served in that capacity from May 1981 to September 1983, testified that "given the immensity of the universe, the resources of the OPWBP are grossly inadequate." [5] Finally, Ian Lanoff, whose tenure as OPWBP Administrator spanned from 1977–81, testified that the problems within the Department of Labor are primarily attributed to "a lack of resources and internal management problems." He testified that due to lack of resources, there is now insufficient personnel to maintain an effective enforcement effort.[6]

Department of Labor statistics on the staff and budget allocated to the ERISA program, as well as several critiques of ERISA's enforcement efforts by entities both within and outside the Department of Labor, strongly support the finding that the ERISA program's resources are, and have been since the program's inception, inadequate for effective oversight of pension plans.

The number of investigative staff assigned to ERISA enforcement within the OPWBP presents a prime example of this problem. As of June 1985, the OPWBP had 215 investigator and auditor positions to police pension and welfare plans. According to Department of Labor statistics, it takes an OPWBP field investigator an average of 24 days to conduct a fiduciary investigation, an average of 84.9 days to conduct a criminal investigation, and an average of four days to conduct an on-site audit of a pension plan.[7] Given these time frames, on-site audits of even only those pension plans with over 100 participants would take over 428,400 staff days to complete. Due to the small number of investigators and auditors available to the OPWBP, only about 2,400 plans are actually reviewed each year, constituting less than one per cent of the entire plan universe. With so few plans being reviewed by the DoL, the chances of ERISA violations being detected by the Department are minuscule at best.

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[4] See Hearing before the Senate Subcommittee on Oversight of Government Management of the Committee on Governmental Affairs, 99th Congress, "Department of Labor's Enforcement of the Employee Retirement Income Security Act (ERISA)," June 25 and 26, 1985 (hereinafter Hearing Record), at 8.

[5] Hearing record at 14.

[6] Hearing record at 86.

The Subcommittee strongly believes that this staffing level is insufficient to provide meaningful oversight of pension plans and their fiduciaries and jeopardizes the pension protections established by ERISA. At the hearings, Mr. Clayton summarized the dangerous effect that inadequate ERISA enforcement resources can have on pension plan participants and beneficiaries:

> Ironically we have created a situation through the enactment of ERISA and the establishment of OPWBP which may breed problems in the future. That is plan fiduciaries can say to the world, "Don't worry about us, we are regulated by a strict statute, so leave us alone," while in reality, they are poorly regulated and for the most part are free to do what they wish.[8]

The Subcommittee believes that the level of resources devoted to the ERISA program sorely ignores the importance of this program to millions of American workers and retirees, as well as to the nation's economy as a whole.

While the Subcommittee recognizes that the problem of scarce budgetary resources is not unique to the ERISA program, especially in this time of high federal budget deficits and trends toward fiscal restraint, we believe that the staff and budget levels given to this program have dangerously compromised the ability of the Department of Labor to enforce the law. Further, the Subcommittee strongly believes that, in this case, the lack of resources is simply a symptom of a larger concern: that the ERISA program has not been given adequate priority by the DoL.

Several factors have contributed to the low priority that has been assigned to ERISA. During much of its 11-year history, the ERISA program suffered from an organizational structure that denied it effective representation at the top levels of the Department of Labor. From 1977 to 1984, the OPWBP was housed within the Labor Management Services Administration, which had enforcement responsibility for the Labor-Management Reporting and Disclosure Act of 1959 (LMRDA), as well as for ERISA. This organizational structure created both political and enforcement problems for the OPWBP. First, the OPWBP Administrator reported to the Assistant Secretary for the LMSA, who was not an expert in the ERISA program. By not reporting directly to the Secretary of Labor, the OPWBP often lacked representation of its interests when competing for limited budgetary and staff resources. Being part of the LMSA also prevented the OPWBP Administrator from having full authority over his field staff, thus impeding the coordination between the regulatory policy established at the national level with the enforcement policy being implemented in the field.

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[7] Final Report of the ERISA Enforcement Working Group, U.S. Department of Labor, July 30, 1984, Hearing Record at 249, 256.

[8] Hearing record at 71.

Many of the problems created by the combined LMSA-OPWBP program were documented by the Department of Labor Inspector General in a March 22, 1984, report entitled "Recommendations for LMSA Reorganization." The DoL Inspector General concluded, for example, that while the assets, coverage and membership of pension and employee welfare plans under the jurisdiction of the OPWBP significantly exceed those of unions under the enforcement jurisdiction of the LMSA, the budget and staff resources were roughly equivalent for both pension and union enforcement efforts.[9] In other words, more resources should have been devoted to the OPWBP side of the LMSA.

In 1984, then Secretary of Labor Raymond Donovan took the important step of separating the OPWBP from the LMSA, making the OPWBP a distinct entity within the Department of Labor. This signaled the first time in over seven years that the Department of Labor took a major step in addressing structural deficiencies of the ERISA program. Since that time, the Department has, as this report will outline, taken other important steps to elevate the ERISA program. Nevertheless, the historic neglect of the ERISA program by the Department has, in the Subcommittee's opinion, seriously compromised the federal government's ability to enforce the important provisions of the law.

All three former Administrators who testified at the Subcommittee's hearing expressed concern over the level of attention that the Department of Labor has paid to the ERISA program. Mr. Clayton, for example, stated that "for much of its history, the OPWBP has had many dedicated professionals who have been swimming upstream against a current of internal departmental politics which has sapped much of its energy." [10] Similarly, Mr. Monks has characterized the ERISA program as being the "stepchild" of the Department of Labor.

While these two former administrators believe that the Department of Labor has, to a large degree, failed to give ERISA the priority it deserves, former Administrator Ian Lanoff disagreed with this assessment. Rather, he testified that the problem of ERISA enforcement stems from the many competing priorities, such as the Occupational Safety and Health Administration and mine safety programs that are also responsibilities of the Department of Labor. According to Mr. Lanoff, it would be difficult for the Department of Labor to place ERISA above these other concerns.[11]

While the Subcommittee recognizes that many other programs within the Department also warrant high priority, we strongly disagree that the Department of Labor has given ERISA the attention it deserves vis-a-vis these other programs. At the hearing, Senator Cohen commented on this issue:

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[9] Recommendations for LMSA Reorganization, Office of Inspector General, U.S. Department of Labor, March 22, 1984, Hearing Record at 723, 730.

[10] Hearing record at 65.

[11] Hearing record at 20.

> There is a tremendous amount of money flowing into these funds and because of either lapses in statutory language, division of authority and responsibility, inadequate resources, old information, or perhaps questions about corporate governance, we have the potential for a major scandal . . . That is the reason I think we ought to be elevating this particular facet of the Department of Labor's responsibility to a much higher visibility. It is more important now and it is going to assume more and more importance in the future.[12]

The Department of Labor today faces the significant new challenge of administering ERISA at a time of unprecedented mergers of corporations in which private pension funds are major shareholders. The Department, however, is struggling to meeting its traditional responsibilities in enforcing the law, raising questions about its ability to respond effectively to this growing trend.

The Subcommittee concludes that the importance of pension funds, both to the nation's economy as a whole and to individual workers and their families, dictates that the Department act swiftly to elevate the priority of the ERISA program.

B. LACK OF A CONSISTENT LONG-TERM ENFORCEMENT STRATEGY

Resource inadequacies have not been the sole problem impeding ERISA enforcement efforts. Instead, the Subcommittee found that several deficiencies have existed in the DoL's ERISA program and have gone uncorrected by the Department of Labor for some time. One major problem found by the Subcommittee was the failure of the Department to adopt a consistent enforcement strategy within the OPWBP. The Department of Labor has changed its enforcement strategy repeatedly over the past 11 years, resulting in fragmented enforcement efforts to detect violations of ERISA.

The frequently changing enforcement approaches adopted by the OPWBP have been well-documented in several reports and were cited as impediments to ERISA enforcement at the Subcommittee's hearing. In its early years of operation, the OPWBP program emphasized voluntary compliance and placed most of its resources on technical assistance and education in order to familiarize plans with the requirements of ERISA. In 1978, the OPWBP shifted its emphasis away from technical assistance to enforcement of the fiduciary duties. At that time, under Administrator Ian Lanoff, the OPWBP adopted the "significant case approach," under which the OPWBP focused enforcement efforts on large plans. Cases with high litigation potential, cases in which substantial assets or number of participants were involved, or cases which were identified with past ERISA violations received high priority under this approach.

In May 1982, a joint Office of Inspector General-LMSA Task Force Report, the so-called "Walsh Report," rejected the significant case approach as being unproductive and placing too little emphasis on other types of ERISA violations. If found, for example, that insufficent attention was given to investigations of small plans, criminal investigations, and deficient annual report filing.[13]

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[12] Hearing record at 138.

In response to the Walsh Report, as well as to criticism of the significant case approach from the Senate Labor Committee, the OPWBP once again altered its enforcement strategy. In 1983, under Administrator Jeffrey Clayton, the OPWBP redirected its enforcement policy to give greater attention to investigation of smaller plans, criminal activity, and fiduciary violations.

In addition to the debate over whether emphasis should be on large plans or smaller plans, a major debate has been over whether the Department should place more emphasis on criminal or civil enforcement efforts. At the hearing, Mr. Clayton noted there has been infighting within the OPWBP program over which aspect of enforcement should dominate:

> In OPWBP from the beginning, there has been a debate between the criminal enforcement advocates (the gum shoes) and those advocating a primarily civil regulatory enforcement program similar to the Securities and Exchange Commission or civil enforcement at the Internal Revenue Service. The gum shoe advocates are primarily old-line Department of Labor people, many of them from the old parent agency of OPWBP, the Labor Management Services Administration. There has been constant bureaucratic infighting over the years as the gum shoes tried to obtain dominance over the newer OPWBP staff members, particularly those who were transferred from the Internal Revenue Service under the 1978 reorganization order. As a result over the years the enforcement strategy has waved to and fro from a greater emphasis on criminal enforcement to a greater emphasis on criminal enforcement. During the time I was Administrator, LMSA proposed that the OPWBP investigators be given the authority to carry fire arms and conduct more FBI criminal type investigations.[14]

The civil versus criminal enforcement debate has contributed greatly to the fluctuating enforcement strategy of the OPWBP. At the hearing, Senator Cohen noted how the Congress has, in recent legislation, mandated more emphasis on criminal investigation:

> Senator COHEN. I might point out, Mr. Clayton, that Congress must bear a large measure of responsibility in inflicting upon the Office the criminal duties. By the passage of the Comprehensive Crime Control Act last year, we mandated that the Office undertake criminal investigations.
>
> I might point out that as we have increased the burdens of the Office we have also seen a decrease in the amount of staff and a reduction in the budget.[15]

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[13] See Report Evaluation and Recommendations, ERISA Enforcement, Joint OIG–LMSA Task Force, U.S. Department of Labor, May 1, 1982, Hearing Record at 536.

[14] Hearing record at 60.

[15] Hearing record at 13.

The Subcommittee believes that the numerous debates over enforcement strategy, whether it be criminal versus civil, large plans versus small plans, or fiduciary versus non-fiduciary violations, have resulted in vague, undefined goals of ERISA enforcement. In 1984, the ERISA Enforcement Task Force and the Office of Inspector General concluded that the failure of the OPWBP to define its enforcement strategy clearly had weakened its enforcement efforts.[16]

In October 1985, the General Accounting Office concluded that, despite repeated criticism of the OPWBP for failure to define its enforcement strategy, the OPWBP still had not done so. In its report, the GAO discussed the importance of a clear, long-term enforcement strategy for the OPWBP:

> We believe the development of and adherence to a sound long-term strategy is important in the pension program because of the frequent turnover of key program officials. For the 10-year period that OPWBP was a part of the Labor Management Services Administration, there were five Assistant Secretaries. Since 1974, there have been seven Administrators of the OPWBP and eight Assistant Administrators of the Office of Enforcement. The adverse effects of this turnover were alluded to by the ERISA Enforcement Working Group, which reported that throughout the program's history, no consistent enforcement policy has been maintained beyond the tenure of the person with primary responsibility for implementing it.[17]

The GAO concluded that even though the OPWBP has communicated its enforcement strategy in a Compliance Strategy Document, this policy does not provide specific specific direction to field offices on how to identify plans for probable ERISA violations.

The Subcommittee believes that the problem of a vague enforcement strategy has gone uncorrected for too long. It is crucial that the DoL act expeditiously to establish a uniform, consistent approach to ERISA enforcement. Only in this way will the Department's enforcement program be a realistic deterrent to potential violators of the law.

One means of developing a comprehensive enforcement strategy would be through a computer-assisted targeting project. Such a project would involve analysis of financial data supplied on annual reports and other data available to the OPWBP to determine which plans shoud be chosen for audit. In 1984, the Office of Inspector General found that although the OPWBP has conducted several targeting projects, most of the projects have not been implemented thoroughly enough to evaluate their effectiveness in detecting ERISA violations. The IG found, for example, that field offices were not required to open cases based on the national office's referrals and that many of the referrals made by the national office were ignored in the field.[18]

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[16] See Supra note 7, Hearing Record at 263; Supra note 9, Hearing Record at 751.

[17] "Strong Leadership Needed to Improve Management At The Department of Labor," United States General Accounting Office (GAO/HRD-86-12), October 21, 1985, at 39.

[18] Supra note 9, Hearing Record at 744-46.

The IG also found that the OPWBP field offices have developed a wide variety of their own targeting techniques. Methods for case selection range, for example, from "sophisticated analysis of plan financial and industry data to audits initiated as the result of tips." In some offices, it is the responsibility of each investigator to decide which plans are selected for review, while in other offices the supervisor makes this decision. These variations in targeting techniques have brought wide disparity among offices in the success of their methods: the percentage of unsuccessful cases in area offices in FY 83, for example, ranged from a high of 93 per cent to a low of 35 per cent.[19]

While the Subcommittee believes that relying on the techniques of experienced investigators in the field may, in many instances, produce successful audits, the OPWBP must develop a more systematic, scientific method of choosing plans for review. This is especially important in light of the scarce resources available to the Department to enforce ERISA: when too few dollars and staff already exist to oversee the enormous universe of pension plans, the Department of Labor should take as many steps as possible to ensure that its enforcement resources are being used effectively and efficiently. Therefore, the Subcommittee recommends that the National Office of the OPWBP initiate a computer targeting program, at least on a pilot project level, that is coordinated with its field offices, and closely evaluate the results of the targeting techniques to determine their effectiveness in detecting ERISA violations.

C. Additional Deficiencies in the OPWBP's Enforcement Efforts

Another major deficiency that has hampered the OPWBP's enforcement efforts for some time has been the quality of the OPWBP's training programs. Once again, despite repeated criticism by several studies, this problem has gone uncorrected by the Department of Labor.

In 1982, for example, the Joint OIG-LMSA Task Force of the Department of Labor concluded that the training efforts of the OPWBP were insufficient and should be improved. The Task Force concluded, for example, that the National Office had effectively cancelled all broad training programs and had developed no organized approach to training. The Department's justification at that time for the lack of a clear training approach was severe budget constraints at the national level. In reaching its findings, the Task Force issued several recommendations on how to improve training efforts, such as the establishment of a written training plan to be disseminated to all OPWBP enforcement staff, the creation of a training office staffed with a full-time professional training staff person, and adoption of formal comprehensive career development programs for OPWBP's enforcement staff.[20]

Despite these findings and recommendations made to the DoL in 1982, the ERISA Enforcement Task Force and the General Accounting Office more recently have found that training continues to be a problem hurting enforcement efforts. In 1984, the ERISA Enforcement Task Force concluded that the national office of the OPWBP has done "much less than it should in the area of training." [21] Moreover, the Task Force noted that the national office's involvement in training has become even more important in light of the elimination of several regional offices of the OPWBP, which have historically provided the main source of on-the-job training for the enforcement staff. Once again, several recommendations were made on how to enhance training efforts, such as development of in-house training at the national level, reliance on outside sources of training for particular specialized areas, such as real estate and banking, and development of specialized training for selected investigators when authorized by the national office.[22]

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[19] Id. at 746.

[20] Supra note 13, hearing record at 588-89.

Even with its own ERISA Enforcement Task Force's finding that training was deficient, the DoL did not act promptly to improve its training efforts. As recently as October 1985, the GAO concluded that training had still not improved within the Department. The GAO reported, for example, that 12 of the 14 OPWBP program managers interviewed in field offices and the national office indicated that they did not believe that the DoL's professional training and development programs had been effective in improving employee performance. Most of the managers indicated that the lack of adequate training has affected their operations and that their staff work could improve if training were provided in certain specialized areas.[23]

The OPWBP has informed the Subcommittee that it has, over the past few months, devoted much more emphasis to training of its national office and field staffs. Moreover, in a December 12, 1985 letter to Senator Cohen commenting on the findings of the GAO, Secretary William E. Brock stated that "the OPWBP has given recent focus to the subject of training and will be conducting an intensive training program early in 1986 on the ERISA statutory responsibilities and investigative skills. In addition, several other smaller training programs were held during Fiscal Year 1985." [24]

While the Subcommittee is encouraged that the Secretary of Labor now recognizes the need for additional training efforts within the ERISA program, we are concerned that the training deficiencies were uncorrected for so long. Because training is an important means of improving the quality of enforcement within limited budgetary and staff resources, the Subcommittee believes that the DoL must place strong emphasis on improving its training programs and urges Secretary Brock to actively pursue this goal.

Closely related to the training problems of the OPWBP are other problems in the Department's investigations of potential violations of ERISA. At times, cases which have taken months or years to develop are returned to the investigator by the DoL's Solicitor because the evidence in the case is legally insufficient for prosecution. In other instances, the discovery process undertaken by the Solicitor's Office for litigation duplicates the investigative steps of the OPWBP because the OPWBP staff did not perform the investigation in a form that is usable for litigation.

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[21] Supra note 7, hearing record at 314.

[22] Id.

[23] Supra note 17 at 41.

[24] Letter to Senator William S. Cohen, Chairman, Subcommittee on Oversight of Government Management, from Secretary William E. Brock, U.S. Department of Labor, December 12, 1985.

Both the National Pension Forum and the ERISA Enforcement Task Force concluded that these problems and delays inhibit the enforcement efforts of the OPWBP. To improve the coordination between the Solicitor's Office and to produce more expeditious investigations in usable form for litigation, these groups recommended that the OPWBP be given authority to hire its own attorneys pursuant to the specially delegated "Schedule A" hiring authority, as is now available to such independent agencies as the Federal Trade Commission and the Securities and Exchange Commission.[25] The Subcommittee endorses this recommendation to provide additional expertise within the OPWBP, thus improving the quality and timeliness of investigations. The Subcommittee is pleased that, according to Solicitor of Labor Francis X. Lilly's testimony at the hearing, the DoL is acting to obtain this authority for the OPWBP.[26]

Another deficiency in the ERISA program cited by the Department's own ERISA Enforcement Task Force is the lack of follow-up on initiatives that have been undertaken by the DoL to improve enforcement. The Task Force's report, for example, stated that inadequate follow-up has been a problem in all areas of enforcement, such as training, targeting, voluntary compliance, and referrals of possible ERISA violations to other agencies.[27]

A prime example of this failure to follow up on enforcement actions is in the referrals made by the Department to the Internal Revenue Service for imposition of an excise tax on certain persons who engage in prohibiting transactions with tax-qualified employee benefit plans. In 1983, the DoL entered into an agreement with the IRS which provides for transmission to the IRS by the DoL of certain cases which the Department believes are appropriate for imposition of an excise tax. From the period of June 1, 1983 to May 2, 1984, 390 cases were sent to the IRS after an investigation by the OPWBP, the majority of which were referred for the imposition of an excise tax. The ERISA Enforcement Task Force found that of these cases, 123 of the referrals involving prohibited transactions had been closed by the IRS, with 107 being closed with no action, and only 16 resulting in the imposition of an excise tax.[28]

At the hearing, Alan Lebowitz, then Acting Administrator of the OPWBP, disputed the findings of the ERISA Enforcement Task Force in this area, stating that the amount of money collected by the IRS as a result of cases referred by the DoL has actually increased from $556,000 in fiscal year 1983 to an estimated $5.4 million in fiscal year 1986. Mr. Lebowitz recognized that the imposition of an excise tax is a "particularly powerful disincentive to abuse since it applies automatically and can be imposed in a relatively simple administrative process by the Service."[29]

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[25] Final report of the National Pension Forum of the ERISA Advisory Council, U.S. Department of Labor, 1984, Hearing Record at 229; supra note 7, Hearing Record at 285–89.

[26] Hearing record at 153.

[27] Supra note 7, hearing record at 311–16.

[28] Id. at 281.

The Subcommittee agrees that an excise tax is a particularly useful enforcement tool that is available to the government for ERISA violations. In light of the questions that have been raised over the extent to which an excise tax has actually been applied for violations of the prohibited transaction rules, the Subcommittee believes that the DoL and the IRS should actively review their 1983 agreement regarding referrals to determine whether improvements are necessary to ensure full enforcement of these penalties. Moreover, the Subcommittee believes that the OPWBP should institute formal follow-up procedures for all referrals that it makes to the Internal Revenue Service, the Department of Justice, and other agencies for probable violations of ERISA.

D. SEVERE DEFICIENCIES IN INFORMATION HANDLING

A major focus of the Subcommittee's investigation was on the OPWBP's use of information supplied by pension plans in its enforcement efforts. The Subcommittee was greatly concerned by allegations that the Department of Labor is far behind in processing the annual reports filed by pension plans and that, even when they are processed, no systematic procedure exists for using them to choose plans for audits and investigation. The Subcommittee received several views on the adequacy of DoL's current information practices and ERISA's reporting requirements from plan sponsors, service providers, ERISA practitioners, and Department officials.

The major ERISA report filed by pension plans is the Annual Report Series, also known as the Form 5500 Series reports. These reports, required by section 103 of ERISA, must be filed by each pension and employee benefit plan. The reports provide a financial statement of a plan's condition and annual financial activities. The amount of information included in the annual reports varies according to plan size. Plans with over 100 participants, for example, must file the Form 5500, which has approximately 220 information items and averages 12 pages in length, while smaller plans file less extensive reports. Approximately 960,000 pension and welfare plans will have submitted the 1984 5500 Series Report, including the reports filed by small plans. Currently, the OPWBP maintains over 5 million annual reports in its files.

Annual reports must be filed with IRS service centers within seven months of the close of a plan year. The IRS staff reviews the forms to determine if all items are reported and proceeds to keypunch approximately 50 per cent of the items on the forms to be used for tax purposes. The hard copies of the reports are sent to a DoL contractor for microfiching for use in DoL's public disclosure room. After the IRS finishes keypunching the data, it sends the magnetic tape containing the keypunched information to the Labor Department. The national office of the OPWBP retains the magnetic tape of the 5500 form information and uses this information for investigations of plans. The National OPWBP sends microfiched copies of the annual reports to its field offices for investigations of plans.

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[29] Hearing record at 140.

Theoretically, the 5500 forms filed by pension plans should be an ideal source for initiating investigations under ERISA. If used to their maximum potential, the form 5500s could provide accurate data bases of the entire plan universe, disclose relevant financial information about each plan, its services and expenses, and could be used to direct enforcement efforts of the OPWBP. These reports are also used by the DoL to fulfill the public reporting and disclosure responsibilities under Title I of ERISA and for research purposes. The Subcommittee found, however, that current problems in the system of collecting and using the 5500 forms significantly reduce the value of the reports for investigative purposes and, in turn, reduce the enforcement efforts of the OPWBP. These same problems also severely limit the ability of the DoL to fulfill its reporting and disclosure and research responsibilities under ERISA.

The General Accounting Office, the DoL Inspector General, the ERISA Enforcement Task Force and the National Pension Forum have all identified significant problems in the annual reporting system which impede DoL enforcement efforts.[30]

The two major deficiencies of the current system are the age and incompleteness of the data received by the DoL. First, pursuant to section 104 of the law, a plan is not required to file an annual report with the IRS until seven months after the close of the plan year. If the report is in perfect condition, it takes the IRS between three to five months to keypunch the data and make a tape available to the DoL. The microfiching process at the DoL takes approximately two to three additional months. Thus, assuming the process runs on schedule, information received by the DoL is over a year old once it is in usable form.[31]

The information is even older when the initial form 5500 filed with the IRS is missing required data. Since 1983, in response to criticisms by the GAO that the 5500 reports being filed were incomplete, the IRS has reviewed the reports to determine whether 15 predesignated items have been completed on the forms. If one of these items is missing, the form is retained for approximately 60 days while a letter is sent to the plan requesting the missing information. Regardless of whether the missing information has been received, the report data are keypunched after the 60-day period. Thus, annual report information for these plans can be over 15 months old when it is in final microfiched form at the DoL.

In March 1984, the Department of Labor's Inspector General reported that eight field offices of the OPWBP (then part of LMSA) commented that the age of the microfiched 5500 forms limited their effectiveness as an enforcement tool. The most current microfiched data found in field offices in 1984, for example, were 1981 data. Some field offices told the Inspector General that they no longer request 5500 forms from the national offices and, instead, visit IRS Service Centers to obtain the annual reports for use in investigations.[32]

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[30] See, e.g., supra notes 7, 9, 17, and 25.

[31] Final Report of the ERISA Enforcement Working Group, supra note 75, Hearing Record at 293–300.

[32] Supra note 9, hearing record at 748–49.

The second major flaw in the current system is the incompleteness of the Form 5500 information available to the OPWBP for enforcement purposes. The information from these forms that is on magnetic tape and available to the national office for enforcement purposes is very incomplete. As noted above, only approximately 50 per cent of the information on the form is keypunched at IRS and sent to DoL. Some items that could be important for the OPWBP in targeting plans for investigations are not on the magnetic tapes given to DoL by the IRS. Information about insurance services provided to a plan, for example, is not keypunched by the IRS. The data received by DoL on magnetic tapes are further deficient because data that were missing on the original 5500 form and not received within 60 days of the filing date are never keypunched into the system.

The DoL is currently paying the IRS over $2 million annually to process the 5500 data and spends an additional $1 million annually to microfiche the data. Despite this cost to the DoL, and the extensive costs incurred by the private sector to file these reports, the information is often inadequate to serve as a useful enforcement tool for the OPWBP.

One means of ensuring more complete information on the forms has been instituted by the Internal Revenue Service in the form of civil penalties for deficient annual reports. Civil penalties of $25 per day to a maximum of $15,000 can be levied for reports and schedules omitted or for missing items on Annual Reports designated as "critical." The Subcommittee believes that full enforcement of this penalty, as well as changes in IRS procedures regarding keypunching of missing data submitted subsequently by a plan, and for providing this information to the DoL, is necessary to improve the usefulness of the 5500 data received by the Labor Department.

While these changes in IRS procedures would improve the accuracy of the form 5500 data, the age of the data available to the OPWBP remains a major problem. In 1984, the ERISA Enforcement Task Force and the National Pension Forum concluded that a solid base consisting of information reported on the Form 5500s is crucial to improving enforcement of ERISA. The National Pension Forum's report, for example, concluded that "The credibility of the Department's entire effort under Title I depends on its ability to use the information that is filed in its annual report." [33] At the Subcommittee's hearing, former OPWBP Administrator Robert Monks summarized the crippling effect that the problems in the annual reporting system have on ERISA enforcement:

> [E]nforcement staff must base their investigations on newspaper articles and phone calls—because by the time they have access to 5500 data, the statute of limitations has usually run. It means that the research staff, who are charged by the law with conducting studies that will serve as the basis for pension policy recommendations, are making so-called "forecasts" from material that is several years old . . . It is unthinkable to contemplate the Internal Revenue Service or the Securities and Exchange Com-

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[33] Supra note 25, Hearing Record at 234.

> mission basing their enforcement efforts on financial data anywhere near as inadequate as that for ERISA; effective enforcement depends on the systematic review and audit of annual filings. Indeed, to a great extent compliance with any law turns on some degree of public belief that if a federal return is required, someone in the government will open that return, read it, and act on it if warranted. No such belief whatsoever exists in the ERISA community, as we have heard directly from many of those who fall under its enforcement provisions.

Mr. Monks continued:

> To what end, therefore, this charade? Every year, the executive branch spends between 10 and 20 million dollars and 100 full-time staff years to process ERISA data. Every year, it is conservatively estimated that the private sector spends 120 million dollars just filling out 5500 forms. Yet the end result of the entire process is useless information, and disfunctionality in the programs that depend on it.[34]

Many plan sponsors also question whether the government's actual use of the Form 5500 justifies the many hours spent in preparing and filing these reports. P.W. Binzel, Assistant Treasurer for Investments for Amoco Corporation, informed the Subcommittee that Amoco, for example, spends approximately 30 staffweeks preparing about 60 Form 5500s, of which approximately 15 to 20 staffweeks are devoted to preparing and filing the Form 5500s relating to Amoco's pension plans. Mr. Binzel stated that:

> During preparation time, there is a feeling that our efforts are wasted due to the general belief that neither the IRS nor the DoL will ever review the reports.[35]

The Subcommittee concludes that the government's current procedures for receiving, filing, and using the ERISA annual reports is unworkable and must be improved.

One means to improve the system would be the electronic filing of annual reports. In January 1984, the OPWBP began a pilot project in which approximately 1,000 annual reports were filed electronically on magnetic tape. The project had a broad range of participants, including both plan sponsors and service providers, and included both large and small plans. Concurrent with the implementation of the pilot project, the OPWBP began discussion with other federal agencies which use ERISA information on the feasibility of electronic filing. These agencies, primarily the IRS, the Pension Benefit Guaranty Corporation, and the Social Security Administration, all expressed interest in the electronic filing project. As a result, the Office of Management and Budget established a group to monitor and evaluate the results of the pilot project.

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[34] Hearing record at 48–49.

[35] Letter to Senator William S. Cohen, Chairman, Subcommittee on Oversight of Government Management, from P.W. Binzel, Assistant Treasurer-Investments, Amoco Corp., September 12, 1985, Hearing Record at 837.

The Subcommittee believes that the DoL should actively pursue the feasibility of electronic filing of annual reports on a broadscale basis, as such a system would improve the accuracy and timeliness of data, enable swift scanning and evaluation of 5500 data to target plans and track cases, and reduce review and storage costs to the government. Moreover, it could provide a readily accessible statistical base of information to the DoL on the current status and trends of pension plans and investment.

Janet Brown, who directed the electronic filing project for OPWBP, pointed out that electronic filing is also advantageous to plan sponsors since "over 90 per cent of the filers currently retain the information on computers." Ms. Brown described the plan sponsors who participated in the project as "enthusiastic" about electronic filing.[36]

While we endorse the concept of electronic filing, the Subcommittee stresses that electronic filing alone will not make the Form 5500 a viable enforcement tool. The Subcommittee received ample testimony that the OPWBP should reevaluate the form and content of the annual reports themselves to determine what changes are necessary to make them more useful for enforcement. Former OPWBP Administrator Jeffrey Clayton, for example, testified that:

> There is almost no knowledge as to what information on the 5500 is important to enforcement and what is not. Just prior to my becoming Administrator, the Office of Enforcement did a survey of investigators to determine which elements of the 5500 they felt were most important. The response was varied and there was little consistency. The only real consistency was a statement by most investigators that they would like more information.
>
> A scientific analysis of the 5500 is critically needed to determine what correlation exists between information reported on the 5500 and the apprehension of violators of ERISA. No such study has ever been completed. Before any meaningful review of the 5500 can be done, such a study should be made.[37]

The Subcommittee strongly endorses Mr. Clayton's recommendation that the DoL should review the 5500 form to determine how useful it is to detect violations of ERISA. In 1981, the OPWBP reformulated the 5500C that is filed by smaller plans to make the information more useful for enforcement and, last year, convened a staff working group to conduct a similar review of the entire Form 5500 series. To date, however, no final action has been taken on recommendations made by this group. The Subcommittee strongly recommends that the Department actively pursue this effort, as well as a review to determine the statistical correlation between the information disclosed on 5500 Series Reports and violations detected, in order to determine whether the 5500 series report should be amended.

Since the Subcommittee's hearings on ERISA, the Office of Management and Budget's Office of Information and Regulatory Affairs, which implements the Paperwork Reduction Act, has solicited comments from the public on how the 5500 series reports should be changed to reduce paperwork and to improve their effectiveness. At a symposium held by the OIRA in January 1986, representatives of the OPWPT, the IRS, and the PBGC, for example, had an opportunity to hear public comments on the 5500 series reports. The Subcommittee urges the Department of Labor to work closely with the IRS, the OMB, and other interested parties in its efforts to improve the annual reporting requirements.

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[36] Hearing record at 39–40.

[37] Hearing record at 73–74.

The Subcommittee recognizes that the information required on the Form 5500 is, in large part, mandated by ERISA itself, leaving little discretion to the DoL. Still, the Subcommittee believes that an analysis of the content of the Form 5500 is necessary to determine whether or not statutory amendments are needed to make the annual reporting system more effective. If such an analysis indicates that statutory changes are appropriate, the Subcommittee would urge the Congress to amend the law to implement these improvements.

E. Prohibited Transaction Exemption Process

A particular focus of the Subcommittee investigation was the Department's handling of the prohibited transaction exemption process set forth in section 408 of ERISA. The Subcommittee was concerned by repeated criticism, by both past DoL officials and industry representatives, that the prohibited transaction exemption process is too slow and cumbersome and may result in lost investment opportunities for pension plans.

In reviewing this aspect of ERISA implementation, the Subcommittee considered the current status of the exemption process and several recommendations on how to streamline the process.

1. BACKGROUND: THE PROHIBITED TRANSACTION RULES UNDER ERISA

The fiduciary rules contained in ERISA are intended to protect employee benefit plans from financial losses caused by mismanagement and misuse of assets. In this regard, ERISA specifically bars fiduciaries from engaging in certain transactions in order to prevent conflicts of interest and self-dealing.

Sections 406 and 407 of ERISA enumerate specific transactions that cannot be undertaken between a plan and its "party-in-interest." For example, a plan fiduciary cannot cause a plan to engage in any transaction when he knows, or should know, that the transaction constitutes a direct or indirect:

(1) sale or exchange, or leasing, of any property between the plan and a party-in-interest;

(2) lending of money or other extension of credit between the plan and a party-in-interest;

(3) furnishing of goods, services, or facilities between the plan and a party-in-interest;

(4) transfer of any plan assets to, or use by or for the benefit of, a party-in-interest; or

(5) acquisition, on behalf of any plan, of any employer security or employer real property, in violation of the 10 per cent

limitation of the acquisition and holding of employer securities and real property.[38]

Further, section 406 of the law prohibits certain actions of self-dealing by a plan fiduciary, such as dealing with the assets of a plan in his own interest or for this own account, acting in a transaction involving the plan on behalf of a party whose interests are adverse to the plan's interests or the interests of its participants or beneficiaries, or receiving any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.[39]

The legislative history of ERISA indicates that the prohibited transaction rules were intended as an enforcement device to preserve the integrity and security of employee pension funds. The congressional conference committee on ERISA concluded that it was not possible to enumerate in the law all practices, even those commercially acceptable ones in the banking and investment community, that could create actual or potential threats to pension funds. Thus, the Congress adopted a *per se* rule on prohibited transactions and allowed the Secretary to grant exemptions to the rule.

Generally, the sanctions in Title I are directed at the plan fiduciary who knowingly causes a plan to engage in a prohibited transaction. Specifically, a fiduciary is liable to make good any losses to the plan resulting from a prohibited transaction if he knew or should have known that the transaction was prohibited. The fiduciary is also required to restore to the plan any profits he may have made through his personal use of the assets of the plan, and may be subject to other equitable or remedial relief, such as being removed as fiduciary. The Secretary of Labor may prescribe civil penalties for prohibited transactions involving welfare plans. Also, under Title II of ERISA, the IRS can impose an excise tax equal to five per cent of the transaction for violations of the prohibited transaction rule, increasing up to 100 per cent of the transaction if the violation is not corrected.[40]

2. THE DOL'S EXEMPTION PROCESS

Section 408 sets forth several types of transactions between plan fiduciaries and parties-in-interest that are statutorily exempt from the prohibited transaction rules. Additionally, subsection 408(a) of ERISA provides that the Secretary of Labor may grant conditional or unconditional exemptions from all or part of the prohibited transaction rule. Before granting such an exemption, however, the Department must find that the exemption is (1) administratively feasible, (2) in the interests of the plan and of its participants and beneficiaries, and (3) protective of the rights of participants and beneficiaries.[41]

The Department administers the prohibited transaction exemption program pursuant to procedures established in 1975.[42] Under this procedure, any party-in-interest with respect to a plan who is or may be party to a prohibited transaction may initiate an exemption proceeding by filing an application with the Department. An association or organization representing parties-in-interest or any party-in-interest alone may file for a class exemption. The Department also may propose exemptions on its own motion.

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[38] 29 U.S.C. 1106.
[39] Id.
[40] See Internal Revenue Code, Section 4975.
[41] 29 U.S.C. 1108(b).
[42] ERISA Exemption Procedure (ERISA Procedure 75-1), 40 FR 18471, April 28, 1975.

An exemption application must include detailed information about the plan involved, the applicants, and the transactions for which relief is requested. This information includes a detailed description of the fiduciaries and parties-in-interest involved, a statement of whether the proposed transactions are customary in the industry involved and a description of the hardship or economic loss that would result if the exemption were denied. The application must also contain a statement on why an exemption meets the statutory criteria for an exemption and must disclose information on previous activities of the plan and applicant, such as whether the party-in-interest has ever engaged in a prohibitive transaction or whether the party-in-interest has been sued for breach of fiduciary duty.

After the exemption application has been reviewed by an employee benefit specialist in the OPWBP, a decision is made to propose the exemption or to issue a tentative denial letter stating reasons for the determination. If the review concludes that the transaction is either not prohibited under Section 406 or is already exempt under an existing statutory or administrative exemption, the Department will issue an "interpretive response" indicating that the file can be closed without further action.

The ERISA exemption procedure provides that an applicant may request a conference if the DoL issues a tentative denial letter. A final denial letter is issued if the OPWBP determines, after the conference or review of additional material, that the exemption should be denied.

ERISA requires the Department to follow specific procedures when it decides to grant an exemption.[43] After tentatively deciding to grant an exemption, the DoL must publish a notice of the proposed exemption in the Federal Register that contains a summary of the representations made in the application and a statement of the exemption DoL proposes to grant. Comments from interested persons are requested and, in cases where the exemption applies to the fiduciary self-dealing rule of subsection 406(b), the Labor Department must provide the opportunity for a hearing on the proposed exemption and must make a determination on the record with respect to the statutory criteria of ERISA.

On the basis of the record developed during the comment and hearing period, the Department makes a final decision on the proposed exemption. Notice of the final decision is published in the Federal Register.

In practice, the Department receives no comments on the vast majority of proposed exemptions, and most proposed exemptions are granted routinely after the comment period has expired. The

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[43] 29 U.S.C. 1108.

DoL does have authority, however, to deny an exemption that it has initially approved.

Class exemptions to the prohibited transaction rules are also available from the DoL and are treated similarly to those for individual exemptions. Trade groups representing classes of persons encountering similar prohibited transaction issues are usually involved in the class exemption process.

3. PROBLEMS IN THE PROHIBITED TRANSACTION EXEMPTION PROCESS

Prior to 1978, both the DoL and the IRS were required to agree on the disposition of all prohibited transaction exemption applications. This dual jurisdiction resulted in few exemptions being processed: through December 1978, the Labor Department and the IRS had closed only 609 of the 1,148 applications that had been filed. The average processing time for individual exemption requests was 15 months. In response to criticisms of this slow process, Reorganization Plan #4 eliminated this dual agency review requirement. Since January 1, 1979, all requests for administrative prohibited transaction exemptions, except for limited exceptions, have been submitted only to the Department of Labor.[44]

The Subcommittee found that the exemption procedure has improved significantly since 1978. At the Subcommittee's hearing, Francis X. Lilly, the Solicitor of Labor, testified that the Department has increased the number of individual exemption cases closed to over 900 per year and has reduced the average processing time for both approvals and denials to under five months.[45] The following table summarizes the number of exemption applications filed, processed, and pending for fiscal years 1980–85:[46]

Applications	1980	1981	1982	1983	1984	1985 [1]
Filed	622	736	879	1,074	907	358
Granted [2]	132	145	236	279	232	150
Denied/withdrawn	521	530	539	725	689	347
Pending	317	378	482	552	538	399

[1] Through April 30, 1985.

[2] Includes the following class exemptions: 3 in 1980; 4 in 1981; 2 in 1982; 1 in 1983; 3 in 1984, and 2 in 1985.

Nevertheless, these statistics illustrate that the DoL ends each fiscal year with a backlog of exemption applications that is over half the number of new applications received. Similarly, while the average processing time has been reduced substantially, some applications still take from two to three years to be completed by the DoL.[47]

Since ERISA's passage, the DoL has issued over 30 class exemptions, many dealing with problems of specific industries. The DoL has, for example, permitted certain transactions involving residential mortgage commitments and financing by employee benefit plans and allowed plans to invest in certain transactions involving short-term investments, such as bankers' acceptances, commercial paper, repurchase agreements, and certificates of deposit issued by a party-in-interest with respect to the plan. In 1984, the DoL took a broader approach to the class exemption process when it issued the Qualified Professional Asset Manager Exemption (QPAME), which provided broad relief for transactions where a plan turns its assets over to a bank, insurance company, or registered investment advisor to manage.

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[44] See Reorganization Plan Number 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978, 44 FR 1065, January 3, 1979).

[45] Hearing record at 9–10.

[46] Letter to Senator William S. Cohen, Chairman, Subcommittee on Oversight of Government Management, from Secretary William E. Brock, U.S. Department of Labor, June 3, 1985, Hearing Record at 617.

[47] Testimony of Alan Lebowitz, Deputy Administrator, OPWBP, U.S. Department of Labor, at hearings before the National Pension Forum of the ERISA Advisory Council, November 14, 1984.

During its hearings and investigations, the Subcommittee heard diverse views on whether the current exemption process is appropriate to achieve the goals of ERISA while meeting the legitimate investment needs of pension plans. Several of the witnesses at the hearing testified that the exemption procedures, despite improvements that have been made in the process, are still ineffective and unduly impede pension plans' capacity to engage in prudent commercial transactions. George W. Cowles, for example, who represented the Association of Private Pension and Welfare Plans, testified that the exemption procedure places "numerous road blocks in the way of valid and appropriate plan investments." [48] He testified that in addition to causing uncertainty and confusion, the long delays in the exemption process can also result in the loss of investment opportunities that cannot be replaced by the plan's fiduciaries. In many instances, he testified, a plan manager may find it preferable to invest in a lower yielding, less innovative transaction than to wait for the Department to grant an exemption for a prohibited transaction that would bring a higher rate of return.[49]

Former OPWBP administrator Jeffrey Clayton expressed similar concerns regarding the effect of the exemption process. Specifically, he stated that even a three- to six-month wait for a plan to obtain an exemption "is not realistic within the confines of ordinary commercial transactions," as it is impossible for business to conduct transactions with plans which have to wait so long before consummating a deal.[50]

Mr. Clayton's views were echoed by Robert Angelica, the director of pension investments for AT&T. In response to a questionnaire sent by the Subcommittee, Mr. Angelica described the prohibited transaction exemption process as much too slow:

> We have found the Department to be cooperative . . . but overburdened and therefore not able to respond in a timely fashion . . . [M]any investment transactions cannot await such administrative delays.[51]

The Subcommittee found it especially noteworthy that in 1984, the National Pension Forum of the ERISA Advisory Council, comprised of ERISA experts from the government, pension industry, organized labor and the public, concluded that delays caused by the current exemption process can unduly inhibit investment opportunities of pension plans. In its final report, the National Pension Forum stated that:

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[48] Hearing record at 189–90.
[49] Id. at 192.
[50] Hearing record at 76.
[51] Letter to Senator William S. Cohen, Chairman, Subcommittee on Oversight of Government Management, from Robert E. Angelica, Director, Pension Investments, AT&T, September 5, 1985, Hearing Record at 832.

> While the Department's work is respected for its professionalism, the delays are not compatible with the needs in the "market place" for rapid financing. There is some evidence that financiers simply avoid ERISA funds as sources of money because of the perceived bureaucratic problems. There is too much money subject to ERISA to permit this condition to continue. Limiting timely investment possibilities of ERISA-covered funds will potentially damage their rate of return and, accordingly, the benefits to plan participants.[52]

Some of those who believe that the exemption process is too slow view this problem as an unforeseen consequence of the exemption procedure established by ERISA, rather than being attributable to poor performance by the OPWBP. Former OPWBP Administrator Robert Monks, for example, testified that in establishing the exemption process, ERISA's drafters did not anticipate the increasingly sophisticated nature of financial transactions presented in prohibited transaction exemption applications, which are often difficult to analyze, thus necessarily slowing down the exemption process. He testified that ERISA did not foresee that "the flood of exemption applications, time pressures, and meager support would put the Labor Department staff at a distinct disadvantage in trying to keep up with the creativity of Wall Street."[53] Other critics, however, blame deficiencies in the exemption process not on the sophisticated transactions themselves, but on the DoL's attitude toward innovative transactions that are proposed in exemption applications. Mr. Cowles testified that the DoL views certain types of proposed securities or real estate transactions which often inure to the benefit of plans as suspect simply because of their novelty.[54]

While there was substantial testimony at the hearing on the investment obstacles created by the exemption process, there was also significant support for the current process as necessary to prohibit conflicts of interest and self-dealing by plan fiduciaries. Michael Gordon, for example, testified that while, in the abstract sense, investment opportunities may be lost because of the prohibited transaction exemption process, this may be a necessary consequence of safeguarding against abuse by plan fiduciaries. Mr. Gordon cautioned that:

> . . . we have to temper that by realizing that when we say "investment opportunities," these are investment opportunities that are being promoted by insiders to the plan. That's where the greatest dangers of abuse exist, and while they can tout them as being terrific investment opportunities, it should also be understood that their objectivity is somewhat suspect because they're the ones, or

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[52] Hearing record at 239.
[53] Hearing record at 51.
[54] Id. at 192.

> their company or union is going to be the one, that's going to benefit by it.
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> So I think the whole purpose of the prohibited transations and the exemption is to try and present some objectivity in the situation, and if it is such a terrific investment opportunity, then it will be approved.[55]

Former OPWBP Administrator Ian Lanoff similarly viewed the exemption process established by section 408 of ERISA as valuable in protecting against conflicts of interest by plan fiduciaries. He testified that the current process constitutes a strong part of ERISA enforcement by requiring plan officials and parties-in-interest to plans to examine transactions before they engage in them. The most effective element in the exemption process in deterring abuses, according to Mr. Lanoff, is the excise tax imposed for prohibited transaction violations. Without fear of this excise tax, Mr. Lanoff testified, there would be more abuses and conflicts of interest by plan fiduciaries.[56]

Finally, the DoL testified in support of the current exemption process as necessary to protect pension plan beneficiaries and participants from self-dealing and conflicts of interest, even though lost investment opportunities may, at times, be a consequence of this process. Mr. Lilly stated that:

> I think that the people at the Department who are engaged in this process would also agree that it oftentimes takes them a very long time to do things, that in that period of time when those transactions are not yet approved, investment opportunities might be missed.
>
> At the same time, as you indicated, their approach is one of caution because many of these class exemptions . . . are really almost in the nature of regulations; that is, they affect an entire class of transactions as opposed to one transaction.
>
> The regulatory process as well takes an inordinately long time because of the various steps that it has to go through.[57]

4. OPTIONS FOR IMPROVING THE EXEMPTION PROCESS

The Subcommittee received a broad range of opinions on how to improve the exemption process. Many of those who believe the problems are caused by the statute itself, rather than how the exemption process has been implemented, advocate a return to the "arms length, adequate consideration" standard that was in effect prior to ERISA. Under this standard, if a transaction which otherwise violated section 406 were, in fact, at arm's length and for full consideration, it would not be a violation of the Act. This view, which was offered by Mr. Clayton and the APPWP at the hearing, has been proposed in several bills in the last few Congresses.[58] Mr.

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[55] Id. at 99-100.
[56] Id. at 23-24.
[57] Id. at 143.
[58] See Hearing Record at 76-78, 190-91.

Clayton recommended that to make this standard more enforceable, the party claiming the benefit of this exemption would bear the burden of proof to show, if challenged by the Department, that the transaction was at arm's length and prudent.[59]

The Subcommittee believes that, while delays and potential lost investment opportunities are consequences of the current exemption process, the Congress should not return to the "arm's length, adequate consideration" standard without first exploring means of expediting the current exemption process established by ERISA. Options which may be feasible to accelerate exemption processing within the confines of the current law, discussed further below, include obtaining the expertise of outside entities to assist the DoL in reviewing exemptions and placing more emphasis on class, statutory, or prototype exemptions.

While recognizing the considerable problems created by the current law, the Subcommittee believes that a return to the "arm's length, adequate consideration" standard would present serious dangers of flagrant types of conflicts of interest and abuse by plan fiduciaries. A shift in the burden of proof to the plan fiduciary to show that the transaction is truly arm's length, as suggested by Mr. Clayton, would facilitate enforcement of the standard somewhat; however, a return to this standard would present additional enforcement problems for the Department at a time when the OPWBP enforcement resources and capacities are already sorely strained.

The Subcommittee received several recommendations on how to improve current exemption processing without changing the prohibited transaction standard in the current law. One major area of discussion at the Subcommittee hearing was the DoL's December 1984 request for comments on the feasibility of a self-regulatory organization (SRO) to assist in the development of prohibited transaction exemptions.[60] The DoL issued this request for comments pursuant to the recommendation of the National Pension Forum, which had been established by Secretary of Labor Donovan in 1984. The National Pension Forum concluded that the DoL should explore the concept of a self-regulatory organization as a potential means of reducing the delays by involving the private sector in the exemption process, especially in exemption applications involving complicated financial transactions.[61]

While the request for comments did not establish a definitive organizational structure for an SRO, it did outline potential functions that the SRO could perform. The Department modeled its proposal primarily on the current use of SROs in the securities law area. It cited, for example, the role that the National Association of Securities Dealers (NASD) plays in promulgating, maintaining, and enforcing a code of business ethics among over-the-counter brokers and dealers. The NASD has been registered with the Securities and Exchange Commission pursuant to section 5A of the Securities and Exchange Act of 1934, which provides for the creation and registration of SROs to establish and promote principles of trade in the securities business.[62] In its request for comments, the DoL cited the NASD as a good example of how the Federal Government has been able to "limit its involvement and expenditures in monitoring the activities of the securities industry," without totally abrogating its regulatory and enforcement responsibilities.[63]

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[59] Id. at 76–78.

[60] "Participation of Self-Regulatory Organizations in the Prohibited Transaction Exemption Process," Solicitation of Comments, Office of Pension and Welfare Benefit Programs, U.S. Department of Labor, 49 FR 48111, December 10, 1984, Hearing Record at 511.

[61] Hearing Record at 239.

The request for comments suggested three potential functions for an ERISA SRO. First, an SRO could provide a valuable source of expertise to the Department in reviewing prohibited transaction exemption applications, especially in the case of sophisticated financial transactions. Specifically, the staff of the SRO would evaluate and make recommendations on exemption applications and make its analysis available to the OPWBP. The SRO and the DoL would develop guidelines on how the SRO would evaluate exemption applications.

A second function of the SRO would be that of a "regulatory negotiator" in developing class exemptions. Under this function, the SRO would help identify the major issues involved in financial transactions, as well as data necessary to resolve the issues.[64]

A final role for an SRO offered by the DoL pertained to a class exemption based on membership in the SRO. Under this approach, the DoL could fashion a class exemption from the prohibited transaction rules for under which relief would be conditioned on membership in an SRO. Because an SRO would have to be well-established, highly independent, and receive high degrees of public confidence to play this role, the DoL believes that it was premature to recommend this function for an SRO at this time.

Reactions to the SRO proposal ranged from strong enthusiasm to skepticism and opposition. The Department of Labor received 28 comments in response to its *Federal Register* notice.[65] Many of these comments, which included the views of plan sponsors, service providers, and their representatives, applauded the concept of involving the private sector in the exemption process. For example, John L. Casey, investment counsel and former member of the Advisory Council on Employee Welfare and Pension Benefit Plans, stated that:

> . . . By involving fair-minded industry people in a significant way in the processing of exemptions (individuals, class, or DoL-oriented) there is an opportunity to get the job done sooner and better. Result: with the referee and review concept there is (1) feasibility and (2) protection of the interests of the beneficiaries and the plan without eroding any of the protective policies and procedures now in place.[66]

Other comments, however, found problems with the SRO in either theory or practice. Objections to the SRO, submitted to the

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[62] Hearing Record at 513-16.

[63] Id. at 514.

[64] Id. at 515-16.

[65] See, "Possible Use of Self-Regulatory Organizations in the ERISA Prohibited Transaction Exemption Process," Summary of Responses Made To The *Federal Register* Notice of December 10, 1984, OPWBP, U.S. Department of Labor, April 1985, Hearing Record at 517-29.

[66] Letter to the Office of the Administrator, OPWBP, U.S. Department of Labor, from John L. Casey, February 7, 1985.

DoL as well as to the Subcommittee at its hearing, centered around several issues.

First, some commented that there may not be sufficient common interests or characteristics within groups affected by the prohibited transaction process for an SRO to succeed. One ERISA practitioner noted that the commonality of interests that makes an SRO feasible for the regulation of the securities industry is lacking in the employee benefits industry:

> In contrast to these SROs, it is not clear who an ERISA SRO would regulate and how the group would be regulated. Prohibited transaction exemptions are requested by an extremely diverse population: plan sponsors, investment managers, individual and institutional trustees, the insurance industry, the securities industry, the commodities industry, the real estate industry, the venture capital industry, and other individuals or business organizations who may be fiduciaries or parties-in-interest. The only common interest which this group shares is the desire to use or invest plan assets. This is an economic interest which may have little or nothing to do with professional or business interests. The component elements of the group often are in direct competition for the economic benefits associated with plan assets. Their interpretations of the prohibited transaction rules vary, sometimes widely. Moreover, some elements have little or no contact with transactions which require prohibited transaction exemptions.[67]

A second area of concern was whether or not an SRO would actually shorten the exemption process. Many respondents to the DoL's notice believed that an SRO would not reduce exemption-processing delays but may, conversely, lengthen the process by creating another layer of bureaucracy. The Securities Industry Association (SIA) noted, for example, that because ERISA does not allow the DoL to delegate its exemption-granting authorities under section 408, the DoL would be required to conduct a *de novo* review of any recommendation of action by the organization, thus lengthening the process for each exemption request.[68]

The Subcommittee believes that while the concept of involving the private sector in the exemption process is laudable in theory, the Department of Labor should not move toward the creation of an SRO at this time. The Subcommittee shares many of the reservations expressed by those who commented to the DoL on the proposal, specifically with regard to the lack of commonality of interest within the ERISA community for an SRO to work effectively and the potential for additional delays if an SRO were created. Further, the Subcommittee is concerned that an SRO which allows industry respresentatives to pass on exemption requests involving their own or other industries' financial transactions may seriously erode the protections against conflict of interest and self-dealing that are the essence of the prohibited transaction rule. At the hearing, Senator Cohen characterized this problem created by the SRO as "the fox guarding the chickenhouse." [69] The Subcommittee believes that the DoL should not, in trying to expedite process, construct a process that may, even inadvertently, facilitate the types of conflicts of interests that ERISA was intended to prevent.

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[67] Letter to Robert J. Stokes, Esquire, Chairman, Fiduciary Responsibility Subcommittee, American Bar Association, Section on Taxation, from Seth H. Tievsky, Esquire, January 8, 1985.

[68] Letter to Office of the Administrator, OPWBP, U.S. Department of Labor, from the Securities Industry Association (SIA), February 8, 1985.

While the Subcommittee believes that the SRO proposal, as suggested by the DoL, is not the solution, we recognize that the increasing sophistication of proposed financial transactions presents problems for the OPWBP, especially in light of its limited resources. Alternative means of obtaining expert advice, however, are available to the OPWBP. The Subcommittee encourages the OPWBP, for example, to use the expertise of other federal government agencies such as the SEC in analyzing financial transactions. The SIA has noted how the OPWBP could benefit from this approach.

> In our view, however, sources of expertise are presently available to the Department.
>
> For example, in respect of securities transactions, the Securities and Exchange Commission, as well as the SROs established under the federal securities laws, exist as sources of expertise. In our view, such inter-agency coordination, combined with the knowledge and expertise of the interested parties requesting an exemption, and the results of the public comment process, would provide the Department with the information necessary to act on an exemption request.[70]

Similarly, the DoL could, in the Subcommittee's opinion, take more advantage of the ERISA Advisory Council, which has representatives from the plan sponsor, consulting, insurance, investment, and banking industries. The Subcommittee shares the view of the APPWP, whose representative testified at our hearing, that greater use of this resource already available to the Department would be a good first step toward greater involvement of the private sector in the exemption process.[71]

In addition to these means of enhancing the OPWBP's expertise in analyzing proposed transactions, the Subcommittee believes that the DoL must re-evaluate its overall approach to the exemption process to determine whether it can find ways of disposing of requests more quickly without compromising the standards established by ERISA. Former OPWBP Administrator Lanoff, for example, recommended that the OPWBP issue more prototype exemptions covering many of the transactions proposed in exemption requests. At the hearing, Mr. Lanoff stated that:

> When I talk about developing class exemptions, I'm not necessarily talking about the ones that involve sophisticated financial transactions, say, by banks or insurance com-

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[69] Hearing Record at 37.

[70] Supra note 68.

[71] Testimony of George W. Cowles, on behalf of the Association of Private Pension and Welfare Plans, before the Senate Subcommittee on Oversight of Government Management, June 26, 1985, Hearing Record at 192.

> panies or investment advisors. I'm talking about some of the regular run-of-the-mill everyday types of prohibited transactions that occur as the result of small plan sponsors taking back a loan from the plan.
>
> The Department by now has granted so many of those that there's almost a common law of exemption rules. It seems to me it won't be that difficult for the Department personnel to lift out some of the standards they've developed. I think that would eliminate hundreds of applications that are received every year.[72]

A similar means of expediting the exemption process may be through more clearly defining the statutory exemptions to the prohibited transaction rules set forth in ERISA.

In urging the OPWBP to re-evaluate its overall approach to the exemption process, the Subcommittee does not intend, in any way, to criticize the caliber of the staff at the OPWBP. To the contrary, throughout its investigation, the Subcommittee was consistently told of the high quality and dedication of the OPWBP staff performing these functions. Moreover, the Subcommittee recognizes the strides that the OPWBP has made in reducing the backlog and average processing time for exemptions. Nevertheless, because the Subcommittee strongly believes that the current exemption process can still bring about unacceptable delays and lost investment opportunities that can harm the investment returns for pension plan participants and beneficiaries, the DoL must actively seek methods of improving its approach to the exemption process.

F. Recommendations

Over the past two years, the Department of Labor has taken some positive steps to improve the quality of the ERISA program. Much of the renewed interest in the ERISA program developed during Secretary of Labor Raymond Donovan's tenure at the Department. During 1984, for example, the OPWBP was separated from the LMSA, allowing the Administrator of the OPWBP to report directly to the Secretary.

In addition to the separation of the OPWBP, which the Subcommittee views as a vital step in upgrading the priority of the ERISA program within the DoL, the Department has taken several other positive steps to improve the ERISA program. In 1984, the DoL convened the National Pension Forum of the ERISA Advisory Council to undertake a bipartisan, objective review of the DoL's effectiveness in administering the ERISA program. This gathering of representatives from the government, pension industry and organized labor enabled the DoL to discuss and consider recommendations in the areas of information handling, enforcement, rulemaking, organization, and national retirement policy. During the same year, the ERISA Enforcement Task Force was established to review all aspects of the DoL's enforcement efforts under ERISA. Finally, in January 1985, the OPWBP conducted hearings on investment performance and corporate governance issues with respect to pension plans subject to ERISA.

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[72] Hearing Record at 24-25.

While all of these steps taken by the Department represent efforts to identify ways that the Department of Labor can better implement its statutory responsibilities under ERISA, the Subcommittee believes that the Department has not, in several instances, corrected problems raised by these groups or acted on their recommendations. The Subcommittee believes that much more must be done to implement the recommendations made by both these internal studies, as well as by the General Accounting Office and the DoL's Office of Inspector General.

The Subcommittee recognizes that the Department's ability to implement some of these recommendations has been impeded by changes in the leadership of both the OPWBP and the Department of Labor. Consideration of some of the ERISA Enforcement Task Force's recommendations, for example, was delayed in part due to departure of Secretary Donovan from the DoL and the absence of an Administrator of the OPWBP after Mr. Monks resigned from that position in January 1985.

These temporary leadership problems, however, do not exonerate the Department for its longstanding acceptance of serious deficiencies in the ERISA program. For too long, the Department has stated that it "is studying" the problem of ERISA enforcement. The Subcommittee believes that the time has come for strong actions by the Department of Labor to improve the quality of ERISA enforcement. The Subcommittee is encouraged that Secretary of Labor William E. Brock has expressed to the Subcommittee his deep commitment to the ERISA program. Evidence of his commitment to the program is his decision to elevate the agency head of the OPWBP to the level of Assistant Secretary. The Subcommittee believes that upgrading this position will have a very positive effect in making the needs of the ERISA program known at the highest decisionmaking levels of the Department.

Based on the discussion set forth in this report, much more remains to be done to make OPWBP's enforcement efforts credible. Specifically, the Subcommittee recommends that:

(1) the OPWBP be given a line item in the Department of Labor's budget to facilitate congressional scrutiny of the resources allocated to the ERISA program;

(2) the OPWBP establish a long-term enforcement strategy and act promptly to develop a computer-assisted targeting program to identify pension plans for audit and investigation, and evaluate the success of its targeting program;

(3) the Department act swiftly to obtain Schedule A hiring authority for attorneys within the OPWBP;

(4) the OPWBP place high priority on establishing a comprehensive training program for investigators and auditors of the OPWBP;

(5) the Department of Labor establish formal follow-up procedures for cases of probable ERISA violations that are referred to the Internal Revenue Service and the Department of Justice. In particular, the DoL should reevaluate its 1983 Agreement with the IRS for referral of prohibited transaction violations to determine whether this agreement requires changes to improve follow-up of cases referred;

(6) the Department pursue electronic filing of the 5500 annual reports on a broadscale basis; and

(7) the Department revise the 5500 series annual reports to make them more effective tools to the DoL in performing its enforcement responsibilities under ERISA. Specifically, the OPWBP should conduct a study to correlate the information reported on 5500 forms with detected violations of ERISA.

Further, in order to address problems in the prohibited transaction exemption process, the Subcommittee recommends that the Department of Labor:

(1) increase the use of its ERISA Advisory Council as an important source of private sector expertise for analyzing proposed transactions that are subject to the prohibited transaction rules;

(2) seek more inter-agency coordination in order to obtain the assistance of other federal agencies in analyzing proposed prohibited transactions; and

(3) place more emphasis on class exemptions, prototype transactions, and clearer definitions of statutory exemptions as a means of expediting the prohibited transaction exemption process.

The Subcommittee believes that prompt adoption of these recommendations will go far in improving the Department of Labor's implementation of its responsibilities under ERISA, and, in turn, strengthening the protections of pension plan participants and beneficiaries established by this landmark legislation.

V. PENSION FUNDS AND CORPORATE GOVERNANCE

In addition to examining the traditional enforcement issues associated with ERISA, the Subcommittee also investigated the impact of ERISA on corporate governance issues.

A. GROWTH OF PENSION FUND OWNERSHIP AND CONTROL OF U.S. CORPORATIONS

One of the striking economic phenomena of the past decade since the enactment of ERISA is the growth of pension fund assets and the influence they are in a position to exert on the economy. The amount of assets held by pension funds has grown tremendously over the past decade and has almost doubled within the past four years alone. In 1980, for example, private pension funds held assets of approximately $664 billion.[73] This figure grew to an estimated $1 trillion in 1983,[74] and a major portion of these assets, approximately $400 billion,[75] was invested in the common stocks of major American corporations. New equity and corporate bond purchases by ERISA-governed funds amounted to one-half of all the new debt and equity offerings in 1983.[76] In 1984, private pension funds held nearly one-fifth of outstanding U.S. corporate stock and one-third of outstanding bonds.[77]

If current trends continue, some experts estimate that the assets of private pension funds will reach $2.2 trillion[78] by the end of the century, and pension plan ownership of common stock in listed corporations may exceed 50 per cent by the year 2000.[79] Because of these large stockholdings, private pension plans and other institutional investors have the potential to exert considerable influence on the market and corporate America.

Due to the phenomenon of pension funds emerging as influential institutional investors, there has been increasing discussion of what responsibilities ERISA imposes on pension plan fiduciaries in corporate governance matters and, specifically, in the context of voting the stock and responding to tender offers for the stock of corporations which are held in pension fund portfolios. In addition, serious concerns have arisen regarding the use of pension funds to defend against hostile takeover attempts and as an offensive tool in contests for corporate control. Concerns have also been raised regarding the conflicts of interest faced by some plan fiduciaries in making such decisions on behalf of pension funds. The Subcommittee's hearings explored these issues as well as the role of the Department of Labor in enforcing the fiduciary standards under ERISA in the corporate governance area.

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[73] Hearing record at 610.

[74] Id.

[75] Department of Labor estimate based upon projection of self-insured asset data from Form 5500 series reports and upon insured asset data from *Pension Facts*, published by the American Council of Life Insurance.

[76] Administrator's Report to the Secretary, Office of Pension and Welfare Benefit Programs (OPWBP), U.S. Department of Labor, January 20, 1985, Hearing Record at 227.

[77] U.S. Department of Labor, OPWBP, Office of Policy and Research.

[78] Hearing record at 149.

[79] Supra note 76, Hearing Record at 622.

B. FIDUCIARY RESPONSIBILITY

Among the most important aspects of the regulatory scheme established by ERISA are the standards governing the conduct of fiduciaries entrusted with administering plans or investing plan assets. By enacting ERISA, Congress for the first time established a federal standard of fiduciary conduct.

The fiduciary responsibility rules generally apply to all employee retirement and welfare benefit plans covered by ERISA. With certain exceptions, a person is a fiduciary with respect to a plan if he or she exercises any discretionary authority or control over management of a plan, or exercises any authority or control respecting management or disposition of its assets; renders investment advice for a fee with respect to any money or property of a plan, or has authority to do so; or has discretionary authority or responsibility in the administration of the plan.

Each plan must be established and maintained pursuant to a written document which must provide for one or more "named fiduciaries" who are to have authority to control and manage the operation and administration of the plan. If a plan so provides, a person who is a named fiduciary may appoint a qualified investment manager(s) to manage all or part of the plan's assets. ERISA also requires that all assets of a plan, with certain exceptions, must be held in trust by one or more trustees. The trustees have authority to manage and control the assets of the plan, except to the extent that the plan provides that the trustee(s) is subject to the direction of named fiduciary, or the plan provides for an investment committee or authorizes the appointment of an investment manager(s).

The statute requires a fiduciary to discharge his or her duties with respect to a plan solely in the interest of the plan participants and beneficiaries and for the exclusive purpose of providing benefits to the participants and beneficiaries. These duties must be discharged (1) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims (prudence requirement); (2) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly imprudent to do so (diversification requirement); and (3) in accordance with the plan documents and instruments, insofar as they are consistent with the statute.

The statute prohibits certain transactions between the plan and a party-in-interest. A party-in-interest includes the plan sponsor; those rendering services to the plan; unions whose members are participants, and officers and agents of those unions; and officers, fiduciaries and employees of the plan. Fiduciaries are also forbidden to use plan assets for their own benefit or for the benefit of one whose interests are adverse to those of the plan.

Under the statute, a fiduciary who breaches any of the fiduciary responsibilities is personally liable for making good to the plan any losses the plan suffers because of such a breach, and he or she is also required to restore to the plan any profits which he or she has made through the use of plan assets. In certain circumstances, a fiduciary is liable for a breach of fiduciary responsibility by another fiduciary.

C. Exercising Stockholder Powers

1. FIDUCIARY DUTY TO EXERCISE VOTE

The Subcommittee examined the fundamental question of how active the fiduciaries of pension funds must be as shareholders in order to fulfill their legal obligations.

Traditionally, pension fund managers and other institutional investors have played a passive role in corporate governance matters. They have followed what is referred to as the "Wall Street Rule" which "holds that stock held by investors is voted in favor of the position advocated by management; and that disapproval of management's position, when it exists, is appropriately expressed by the sale of stock in that company." [80]

In the 1970's, a trend away from the Wall Street Rule began and has intensified in the 1980's. The abandonment of strict adherence to the rule has been attributed, in part, to the increased size of institutional stockholdings (which, in turn, is to a large degree the result of the rapid growth of pension fund assets), which has affected the liquidity of those holdings. It may be difficult, if not impossible, for a major institutional investor holding a large block of stock in a particular corporation to sell the stock, except possibly over an extended period, without adversely affecting its price or incurring prohibitive liquidation costs.

In addition, there are situations in which an institutional investor may find that a stock investment may be worth retaining despite objections to an action taken or proposed by management. In such circumstances, it may be more advantageous for the institutional investor to retain the stock and attempt to use its influence to change management. Due to the wave of recent mergers and takeovers, this situation has become increasingly prevalent as incumbent managements have taken steps to deter potential takeovers by proposing amendments to corporate charters designed to create barriers to hostile tender offers.

The trend away from the Wall Street Rule and toward greater opposition to certain management proposals, particularly antitakeover charter amendments, has been documented by surveys conducted annually by the Investor Responsibility Research Center (IRRC) on how corporate proxies are voted at corporate annual meetings. Although antitakeover charter amendments proposed by management continue, with rare exceptions, to be approved by shareholders, the IRRC in its 1985 survey found that major institutional investors remain highly skeptical of antitakeover amendments and their opposition to many of them is growing.[81]

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[80] Allen, Julius W., *Institutional Investors and Their Role in Equity Financing and Corporate Governance*, Congressional Research Service, Library of Congress, Report No. 85-163 E., August 29, 1985, p. 25.

Another indication of a growing concern among institutional investors about corporate governance issues, particularly in regard to antitakeover measures, was the formation in January 1985 of the Council of Institutional Investors. The council members include over 20 public pension funds and a small number of labor union funds, and have combined assets of about $100 billion. While most of the council members represent public funds which are not covered by ERISA, the Council is focusing attention on issues that also face the fiduciaries of private funds. The purpose of the Council is "to coordinate responses among major public and labor union pension funds to corporate governance developments involving companies in which the funds are major shareholders. It is particularly concerned about takeover developments . . . which have had an adverse impact on incomes of major institutional investors." [82]

Another factor contributing to the demise of the Wall Street Rule was the passage of ERISA itself and the imposition of federal fiduciary standards which have "heightened sensitivity about the role that pension funds play in the corporate governance process." [83]

During his tenure as administrator of the OPWBP, Robert Monks was outspoken on the responsibilities of pension fund managers to become more active in their role as shareholders, arguing that under ERISA fiduciaries are obligated to evaluate and act on corporate governance issues involving the firms in which the plans hold securities in order to safeguard the plans' assets. In one of a number of speeches on this issue, Mr. Monks stated:

> Simply put, it is the duty of corporate management to do that which is best for the company, not what is best for management. Equally simply put, it is the duty of the fiduciary of a pension plan under ERISA to scrutinize those actions of management which are put to a shareholder's vote and to vote for the course of action which is best for the company, as that will be reflected, sooner or later, in an increase in the value of the company's shares, all other things being equal. Sitting on the sidelines, or blindly voting for management would not, in my opinion, discharge the ERISA fiduciary's duty as shareholder.[84]

As Mr. Monks testified before the Subcommittee, "ERISA plans must be invested and managed for the exclusive benefit of plan participants and beneficiaries. This requirement encompasses the exercise of voting power every bit as much as the investment power." [85]

In January 1985, Mr. Monks chaired the Department of Labor's hearings on pension plan investment practices and corporate governance issues at which investment managers, state officials, academics and others testified. Most of the speakers agreed that pension funds and other institutional investors have a fiduciary obligation to exercise their stockholder powers, especially in voting against antitakeover measures.

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[81] Ellen Flax, *Voting by Institutional Investors on Corporate Governance Questions, 1985 Proxy Season*. Investor Responsibility Research Center, Washington, D.C., October 1985.

[82] Supra note 78, Allen, p. 29.

[83] Hearing record at 200.

[84] Monks, Robert A.G., "The Institutional Investor as a Corporate Citizen," March 15, 1984.

[85] Hearing record at 10.

This view was echoed at the Subcommittee's hearings by former OPWBP administrator Jeffrey Clayton who testified that a "fiduciary has the duty to inform himself of the affairs of the corporation in connection with those matters which might affect the value or the rights which a plan has as a shareholder. The fiduciary then must make a prudent evaluation of the issues and vote the stock accordingly." [86]

Mr. Clayton also expressed concern regarding the tendency in the past of institutional investors to routinely vote with management and stated that:

> In today's world of green mail, poison pills, golden parachutes, and all kinds of creative devices to protect entrenched management, plan fiduciaries have an even greater obligation, particularly when they own large blocks of corporate stock, to keep themselves informed as to corporate governance issues and other issues which affect the value of plan investments and vote accordingly.[87]

While Mr. Lanoff took a more limited view than Mr. Monks on the question of how active fiduciaries must be in corporate governance issues, he agreed with Mr. Monks and Mr. Clayton that fiduciaries are "required to vote their shares to preserve and further . . . [the] economic interest" of the plans.[88]

In the Subcommittee's judgment, the evidence is strong that an ERISA fiduciary who has the power to vote stock has a legal obligation to exercise this authority when questions that may affect the value of the shares come before the fiduciary. To fail to vote, to cast a vote without considering the impact of the question, or to vote blindly with management would appear to violate the mandate of ERISA that the fiduciary must act for the exclusive benefit of the plan's participants and beneficiaries.

2. DELEGATING VOTING RIGHTS

Pension funds, which are the largest category of institutional investments, are only in part self-administered. A large portion of pension funds are administered by banks, investment advisors, insurance companies and other financial intermediaries. According to the 1985 edition of *Money Market Directory*, of the 100 largest corporate pension funds, 58 use outside investment managers exclusively. Many of the other 42 funds use outside investment managers for equity investments while relying on in-house managers only for cash and short-term commercial paper. Smaller pension funds to an even greater degree rely on outside investment managers for their equity investments.[89]

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[86] Hearing record at 79.
[87] Hearing record at 17.
[88] Hearing record at 25.
[89] Supra note 76, hearing record at 686.

It is customary for pension fund officials, when selecting outside investment managers to manage a portion of the fund's investments, to delegate the voting responsibility for the stocks in the portfolio in the investment manager's care as well as the investment responsibility. Even where investment decisions are reserved to in-house managers, a plan is likely to delegate voting responsibility to the fund's bank trustee.[90] There are a relatively small number of pension plans which both manage the fund's investments and exercise the voting rights for the shares in the fund's portfolios internally.

A 1977 study prepared by the Congressional Research Service for the Senate Governmental Affairs Subcommittee on Reports, Accounting and Management concluded that two attitudes are primarily responsible for the frequent delegation by pension plan officials of all responsibility with respect to voting the proxies of the equity shares held by the fund:

> There would appear to be two basic attitudes which could at times well reinforce each other. One is the fundamental belief that it is sound policy for voting responsibility to be congruous with investment responsibility. If a bank trust department, insurance company, or investment company is selected on the basis of its competence to make decisions on the equities in which fund assets are to be invested, it could be expected as well to have the related knowledge and judgment on how to vote the shares in the fund's portfolio in the best interests of the pension fund beneficiaries. Furthermore, pension fund officials may consider the voting of stock more in the nature of a nuisance or a chore that they have little or no interest in. Their interest may be strictly limited to the bottom line profits of their investments, and an indifference to other aspects of the management performance of portfolio companies or the issues that are submitted to stockholders at the companies' annual meetings or in their proxies. Also where a large pension fund portfolio may include common stocks of scores or even hundreds of corporations, it is understandable that fund officials may not want to take the time and effort to investigate the proxy issues that arise each year so as to vote in the considered interest of their fund beneficiaries.[91]

Although this study was completed over eight years ago, the report on *Pension Funds and Corporate Governance* prepared by the Institutional Investor Research Center for the Department of Labor in 1985 concluded that the study's findings and conclusions appear to remain valid.[92]

The Subcommittee explored the division of decision-making authority between plan sponsors and their outside managers and the implications that delegating voting responsibility has on the exercise of shareholder rights pursuant to ERISA's fiduciary standards.

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[90] Allen, Julius W., "The Exercise of Voting Rights By Large Institutional Investors: A Survey," for the Library of Congress, December 1977. Printed by the Senate Governmental Affairs Subcommittee on Reports, Accounting and Management as Part II of a staff study entitled "Voting Rights in Major Corporations," January 1978, pp. 720–721.

[91] Id., pp. 724–725.

[92] Supra note 76, hearing record at 688.

Several of the Subcommittee's witnesses in addressing this question agreed that the statute permits and, indeed, encourages delegation by plan sponsors. As Mr. Lanoff explained, prior to ERISA, many fiduciaries lacking expertise in making investment decisions wasted plan assets as a result. Allowing the delegation of authority to experts was seen as benefiting plans.[93] Mr. Gordon expanded on this explanation when he testified that delegation of responsibility was "deliberately designed to try to professionalize, to the largest extent possible, the carrying out of fiduciary responsibilities, without inhibiting plan sponsors . . . from establishing plans." [94]

Some witnesses saw problems in the delegation of voting authority. In his testimony, Mr. Monks referred to the Department of Labor's summary of the OPWBP's hearings on corporate governance which stated that "voting shareholdings is problematic for several reasons: . . . it is inconvenient for delegatees to exercise; and it creates conflicts of interest." [95] Citing the testimony of Professor Roger Murray, the summary quoted his cogent discussion of the inherent difficulties in delegating voting responsibility:

> The investment manager retains his clients and earns his fees by delivering good performance, which is measured against market indexes at frequent intervals. No plan sponsor adds to the performance measure points for thoughtful consideration of corporate governance issues. On the other hand, voting portfolio shares against the anti-takeover proposals of a present or prospective client is seldom perceived as the best way to cement or create a warm relationship. In short, the direction, if any, must come from the plan sponsor and it will eliminate the manager's conflict-of-interest problem.[96]

The Department concluded that, to the extent that conflicts of interest exist, "it appears unrealistic to expect financial intermediaries to be able to act effectively." [97]

Due to the conflict-of-interest problem that may be created by delegation, some observers have suggested that voting should be the responsibility of plan sponsors. As Mr. Heard noted in his testimony, this "would place responsibility closer to the beneficial owners, whose interests are at stake, and it would relieve financial intermediaries of the conflicts of interest that they often face in voting or in making other decisions related to contests for corporate control." [98]

Pointing out that public plan sponsors generally retain the authority to vote their shares, Mr. Lanoff agreed that private plan sponsors should be encouraged to take back the voting responsibility that they have delegated. He stated that "any pension fiduciary has as much sophistication in terms of voting shares on proxy matters as the money managers do." According to Mr. Lanoff, voting is "mostly a matter of commonsense; [y]ou don't have to be a sophisticated investor to understand what corporate activities are going to do to the value of your shares." [99]

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[93] Hearing record at 34.

[94] Hearing record at 101.

[95] Summary of conclusions from public hearings conducted by the Office of Pension and Welfare Benefit Programs (OPWBT) on Investment Performance and Governance Issues, OPWBP, U.S. Department of Labor, January 1985, Hearing Record at 494.

[96] Id. at 495.

[97] Id.

[98] Hearing record at 208.

Although cautioning that plan sponsors also are likely to find themselves in situations that present conflicts of interest, Mr. Heard agreed that the "idea of shifting responsibility onto the shoulders of plan sponsors may have merit." [100]

The hearings held by the Department of Labor on the investment and voting of securities that are subject to ERISA also explored the question of delegating voting responsibility. The Department, in its summary of the testimony at the hearings, concluded that:

> It is clear that plan sponsors need to act with a greater proprietary sense, possibly by retaining voting rights and by developing new institutions to articulate ownership rights in a way that protects plan beneficiaries.[101]

The Subcommittee believes that the question of whether or not plan sponsors should delegate voting authority to outside managers deserves additional attention. While the Department of Labor's hearings, as well as those conducted by the Subcommittee, have advanced the debate on this issue, the Subcommittee is not aware of any comprehensive survey on the policies and procedures used by pension fund fiduciaries in exercising the voting rights of stock held in pension fund portfolios. As the IRRC study concluded, "there is a need for more complete data about the activities of pension funds in regard to corporate governance issues." [102]

The IRRC pointed out that the Securities and Exchange Commission study on institutional investors, published in 1971, predates the enactment of ERISA, and the Congressional Research Service study conducted for the Senate Governmental Affairs Subcommittee on Reports, Accounting and Management in 1977, predates the emergence of corporate governance issues as matters of concern for public funds. The Investor Responsibility Research Center's more recent surveys provide insights into the policies of major institutional investors, but the Center concluded that more information is needed on the policies of a broader spectrum of investment managers. There is also a lack of information about the voting policies of pension fund sponsors, the IRRC found.

The Subcommittee's interest in this area relates directly to the fiduciary duties imposed by ERISA and possible violations of these duties. The focus of the Subcommittee's investigation was twofold: First, what does ERISA require of fiduciaries in voting the proxies of stock held in pension fund portfolios? And, two, are conflicts of interest resulting in voting decisions by ERISA fiduciaries which are not being made solely in the interests of pension fund participants and beneficiaries?

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[99] Hearing record at 34.
[100] Hearing record at 208.
[101] Supra note 93, hearing record at 468.
[102] Supra note 76, hearing record at 711.

3. ANTITAKEOVER CHARTER AMENDMENTS

One of the most controversial issues facing ERISA fiduciaries with increasing frequency is how to vote on antitakeover charter amendments.

These amendments to a corporation's charter or by-laws are intended to make it more difficult for changes in corporate control to occur. Such devices as "poison pills," staggered boards of directors, and supermajority provisions, are all designed to discourage hostile takeovers.

The managements of U.S. corporations are proposing antitakeover provisions with increasing frequency. From 1979 through 1984, antitakeover charter amendments were approved by the shareholders of more than 450 companies.[103] During the first nine months of 1985, a period of unprecedented acquisition activity, more than 250 corporations submitted approximately 450 antitakeover charter amendments to their shareholders for approval, compared to approximately 200 corporations during the same time period in 1984.[104] Virtually all of these antitakeover amendments were approved.

As the number of antitakeover amendments has increased, so has the debate on whether these measures are designed to protect the interests of shareholders by strengthening the corporation's bargaining position in an increasingly sophisticated takeover environment to enable managements to resist takeover attempts that are not in the shareholders' interest, or whether they simply serve to entrench incumbent management at the shareholders' expense.

Many experts contend that antitakeover charter amendments reduce the value of the corporation's stock because they may preclude future acquisitions that would benefit the shareholders.

A Securities and Exchange Commission study, "Shark Repellents: The Role and Impact of Antitakeover Charter Amendments," published in November of 1984, examined changes in the stock prices of companies that had adopted certain antitakeover amendments between 1980 and 1983. The SEC found that firms that had adopted antitakeover amendments experienced, on average, a two to five per cent decline in stock prices. The SEC estimated the aggregate capital loss to shareholders of these stock declines to be about $1.35 billion. According to the SEC study, substantial literature supports the contention that shareholders also forego potentially large premiums from takeover-related stock price increases that are precluded by the charter amendments. Moreover, antitakeover measures cause a decrease in the accountability of management to shareholders, the report concluded.[105]

In a June 1985 report to the Department of Labor, the Investor Responsibility Research Center presented its analysis of the impact of antitakeover charter amendments. The IRRC found that, on average, shareholders in firms without antitakeover amendments realized a 33 per cent greater premium over the basic value of their corporations' assets from acquisition attempts than stockholders in firms with such amendments. The Center also analyzed the ratio of market price to book value immediately before a takeover bid for firms with and without antitakeover provisions and found that targets with the amendments had, on average, a 41 per cent lower price-to-book value than targets without the amendments. According to the IRRC study, this performance difference suggests that the market perceives the managements of firms with the amendments as doing a "significantly worse job of managing the corporations' assets." [106]

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[103] Statement of John S. R. Shad, Chairman of the Securities and Exchange Commission, before the House Subcommittee on Telecommunications, Consumer Protection and Finance, concerning tender offers, Exhibit C, May 23, 1985.

[104] Supra note 79, p. 1.

[105] *Shark Repellents: The Role and Impact of Antitakeover Charter Amendments,* Office of the Chief Economist, Securities and Exchange Commission, pp. 6 and 17, September 7, 1984.

While pointing out that antitakeover provisions are not necessarily harmful to the economy as a whole, the IRRC study concluded that the evidence:

> . . . strongly suggests that shareholders who oppose antitakeover charter amendments are correct in arguing that shark repellents are contrary to shareholders' interests. The evidence also casts doubt on the assertions that shareholders should approve shark repellents because they will result in a better deal for shareholders if a company becomes a target of a takeover attempt.[107]

In written testimony submitted to the Subcommittee, James Heard, the deputy director of the IRRC, reported on the results of three surveys conducted by the Center since 1981 on how investment managers are voting on antitakover charter amendments. Most of the investment managers responding to these surveys indicated that they believed that antitakeover charter amendments are contrary to shareholders' interests.

This viewpoint was expressed by the money manager who testified at the Subcommittee's hearing—Dean LeBaron. Explaining why he votes against the antitakeover proposals that managements propose, Mr. LeBaron stated:

> Antitakeover charter amendments are agreed to by all academics in studies at least that I'm aware of to be . . . negative on stock prices or, at the very best, uncertain or neutral. I haven't yet read a study that says that they are helpful.[108]

In an interview with Ralph Nader that appeared in the December 1985 issue of *Regardie's*, T. Boone Pickens, the chairman of Mesa Petroleum company, described antitakeover amendments as an attempt by corporate managers to take rights away from the stockholders, the owners of the company. While Mr. Pickens, who has mounted hostile takeover bids for several corporations, might be expected to oppose antitakeover proposals, it is worth noting that Ralph Nader also has described antitakeover amendments as "rigging the process." [109]

While the Subcommittee recognizes that not every antitakover charter amendment is intended simply to protect incumbent management, the weight of the evidence suggests that such proposals often are contrary to the interests of shareholders.

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[106] Supra note 76, Hearing Record at 653–655.
[107] Id., at 656.
[108] Hearing record at 168.
[109] "Nader Grills The Raider, "*Regardie's* December 1985, pp. 80–91, p. 83.

Some investment managers carefully assess the impact of specific antitakeover provisions on shareholders. In fact, certain pension-fund fiduciaries, such as Dean LeBaron, have been in the vanguard of shareholders who have questioned the impact of shark repellents advocated by corporate managements. However, as Mr. LeBaron has noted, antitakeover proposals "do seem to pass, even in companies . . . widely held by institutions or fiduciaries." [110] Almost all of the antitakeover amendments proposed during the past year were approved by wide margins.[111] Given the extensive stock holdings of pension funds, the passage of these antitakeover amendments raises the question of whether or not ERISA fiduciaries are fulfilling their legal obligations to make decisions that are solely in the best interests of the plans' beneficiaries and participants.

4. CONFLICTS OF INTEREST

Despite what may be valid reasons for the delegation of voting as well as investment authority to financial intermediaries, this delegation presents dangers which are of legitimate public concern. Many of the financial intermediaries, such as banks and insurance companies, who manage pension funds have close relationships with corporations beside the investment of funds in them. As James Heard explained in his testimony before the Subcommittee:

> Potential conflicts of interest are not uncommon for investment managers who must observe ERISA's fiduciary requirements and who also wish to cultivate good relations with existing or potential clients. In addition to their responsibilities as fund managers, many banks and insurance companies have other relationships with corporations that create opportunities for conflict. Banks, for example, may serve as commercial lenders to, and insurance companies may be insurance underwriters for, companies whose pension fund they manage. Personal relationships among senior executives, including service on boards of directors of major customers, may introduce additional complications.
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> Reluctance to offend customers is frequently mentioned as one of the principal reasons why institutional investors traditionally have preferred to avoid making voting decisions that are opposed by the managements of portfolio companies. The appearance in proxy statements of antitakeover charter amendments and other items that may diminish the rights of shareholders or affect the value of their investments puts investment managers in a position where they may be required to choose between their fiduciary responsibilities and their own financial interests.[112]

Money managers may be subject to pressure from those corporations for which they manage pension funds or with which they have other business relationships to vote in support of their position on proxy issues. This situation is illustrated by the following hypothetical posed by Mr. Monks in his testimony:

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[110] Hearing record at 170.

[111] Supra note 79.

[112] Hearing record at 203-204.

> Take the hypothetical Company A, whose ERISA funds are managed by Bank B. The Bank also manages pension portfolios for ten other large companies, and has purchased Company A stock for all ten. Enter Company A's pension officer one day, with an additional ten million in pension funds for the Bank to manage, and coincidentally, a small request. Company A's annual meeting is coming up, and a certain anti-takeover measure is on the proxy; Company A surely would appreciate it if Bank B could make sure all the proxies it holds are voted the right way. Needless to say, the Bank justifiably worries about keeping Company A as a valued client. But it holds trustee responsibility for ten other pension portfolios, whose best interests may well lie in Company A being available for acquisition.[113]

During the course of its investigation, the Subcommittee learned of allegations, similar to Mr. Monk's hypothetical, involving a bank which managed a portion of the pension funds for a corporation involved in defending itself against a hostile takeover bid. The bank held stock in the target corporation on behalf of the corporation's own pension fund and other funds as well. The bank was in a key position to influence the outcome of the takeover contest due to its stockholdings in the target company; in addition, it had been approached by the bidder for financing to assist in its acquisition effort. Ultimately, the bank declined to enter into a financial arrangement with the bidder and voted the target company's stock in support of management's efforts to thwart the takeover. Although there is no direct proof that the bank's decision to support the management of the target corporation was based on self interest and was, therefore, in violation of its fiduciary obligations, this situation illustrates the serious conflicts of interest facing some investment managers and how susceptible they may be to client pressure.

Another incident brought to the Subcommittee's attention involves a Massachusetts money management firm where one investment manager allegedly was forced out of the company after he refused to give in to client pressure to vote for certain antitakeover amendments. Supporting these proposals, the manager contended, would violate his fiduciary duty under ERISA to vote the shares held in the pension portfolio he managed in the best interests of the plans' beneficiaries.

Pressure may also be brought to bear on managers from their clients to support proposals of a corporation's management with which they have no business relationship. As described in *Institutional Investor,* even in the situation where a money manager does not manage a portion of a corporation's pension fund assets, the corporation's CEO has ways of exerting influence:

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[113] Hearing record at 53.

> Maybe he can't threaten the loss of his pension account, but he probably knows another CEO who can. With the help of proxy solicitors, many are networking other clients of managers and their company's suppliers to put additional pressure on money managers to vote the party line.[114]

As Mr. Monks pointed out in his testimony: when one considers the few large entities that control the bulk of pension fund assets . . . it is clear there are overlapping networks of connected companies who have commercial relationship with virtually every significant financial service provider. The number of phone calls that could be arranged to a fiduciary with an unacceptable view of exercising his responsibilities boggles the mind. It is a very large number.[115]

Mr. Monks' description of a few large entities controlling the bulk of private pension assets is reflected in Department of Labor statistics. According to the Department of Labor, the largest 100 plans hold approximately 29 per cent of all private pension assets. Many corporations sponsor more than one pension plan and, on an individual company basis, the concentration of assets is even greater. The combined assets of pension plans sponsored by the top 200 companies represent 75 per cent of all private pension assets.[116]

This concentration of assets is also mirrored in the amount of assets managed by the largest financial management firms. The 1986 Pension Directory published by *Institutional Investor* indicates that 25 investment management firms manage nearly half a trillion dollars in assets of pension funds, both public and private, as well as foundations and endowments.[117]

The Department of Labor's published summary of its hearings on corporate governance issues concluded that "the vast and overlapping network of managers and consultants tends to create major conflicts of interest among all of the significant participants in the ERISA system." [118] At the Subcommittee's hearing, Jeff Clayton commented that "for too long there has been too cozy a relationship between some institutional fiduciaries and the companies whose stock the institutional fiduciaries were voting." [119]

As the IRRC's report to the Department of Labor on pension funds and corporate governance acknowledges, it is unclear how often the pressures imposed on investment managers result in voting decision which they, absent such coercion, would have made differently. However, the Subcommittee shares the IRRC's conclusion that it "would be naive to suppose that such instances are either nonexistent or uncommon." [120] Even in those situations where no direct pressure is applied, the fact that a business relationship or the prospect of a future relationship with a client exists, may influence investment managers "to put their own self-interest ahead of their fiduciary responsibilities." [121]

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[114] Joe Kolman, "The Proxy Pressure on Pension Managers," *Institutional Investor*, July 1985, pp. 145–147, at p. 147.

[115] Hearing record at 10.

[116] U.S. Department of Labor, Pension and Welfare Benefits Administration, Office of Policy and Research.

[117] "1986 Pensions Directory," *Institutional Investor*, January 1986.

[118] Supra note 93, hearing record at 485.

[119] Hearing record at 17.

[120] Supra note 76, hearing record at 691.

In his written testimony, Mr. Heard stated that it has been reported to the IRRC that corporations are more aggressively seeking shareholder approval of antitakeover charter amendments and that pressure brought to bear on money managers by corporations has intensified within the past 18 months, as the number of corporations seeking approval of antitakeover proposals has increased. The tactics that corporations are using to win adoption of such proposals "varied from low-key inquiries urging investors to support management proposals to more heavy handed threats involving possible retaliation against institutions that failed to support management initiatives".[122] In some instances, "companies threatened to sever business ties with firms that manage their pension funds or that have other business relationships with them." [123]

Mr. Heard also testified that the IRRC has been told that in a number of instances during this time period certain institutions have changed their voting policies "from one of either opposition or independent analysis to one in which there is across-the-board support" for antitakeover charter amendments in response to the heavier pressures being brought by corporations to support these measures.[124] In its report on voting by institutional investors during the 1985 proxy season, the IRRC noted that:

> . . . several individuals have reported . . . that their institutions have moderated their opposition to anti-takeover charter amendments after they received pressure from clients. One insurance company reportedly changed its policy from voting against anti-takeover proposals to voting in favor of almost all. Another insurance company stopped reviewing proposals independently and instead switched to a policy of uncritical support. A third institution, a major bank, changed its policy from opposition to support of fair price proposals.[125]

The Department of Labor's January 1985 hearings on corporate governance also provided testimony on the strong pressure from corporate clients to which some money managers are subjected. David Heald, vice president of First Chicago Investment Advisors, testified what "We have had certain situations where there were apparent threats . . . suggesting to us that if we proceeded with our particular position they might want to find another commercial banking arrangement." [126]

Also of interest to the Subcommittee was an article in the July 1985 issue of *Institutional Investor* which described a number of instances reported by money managers willing to talk off the record about how pension fund proxy decisions are being influenced by pressure or direct threats from corporate clients. Among the examples cited are the following:

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[121] Id.
[122] Supra note 79, p. 1.
[123] Id., p. 19.
[124] Hearing record at 196.
[125] Supra note 79, p. 20.
[126] Supra note 93, hearing record at 496.

> A major bank trust department changed its policy on antitakeover amendments after complaints from a big client on the commercial side of the bank.
>
> A major insurance company that had established a policy of voting proxies against "fair-price" provisions reversed itself under pressure from several of its largest corporate clients.
>
> Another insurance company, owned by a large industrial company, had a similar, tough policy but is now being advised by its parent company on how to vote on antitakeover amendments—in most cases based solely on the parent's relationships with its client.
>
> A corporate pension administrator received a threat from one of the company's major customers: "Get your money manager to vote for our antitakeover, or we'll stop buying your products." [127]

Another example of pressure was recounted in an article which appeared in *The Wall Street Journal* describing efforts taken by Unocal in its proxy fight with an investor group led by T. Boone Pickens, Jr. According to the article, after having failed to convince financial institutions to support their position in the proxy battle, Unocal officials directly contacted the institution's clients. An unnamed manager at an institution who reported receiving instructions from clients, whose shares the institution holds, to "switch the shares' votes to Unocal from Mesa," was quoted as saying "This is unprecedented here." The article also reported that Unocal had "deployed several hundred proxy solicitors, including Unocal directors who have intervened with some banks." [128]

It is not the Subcommittee's intent to imply that violations of ERISA's fiduciary standards necessarily occurred in this case. The Subcommittee has not investigated the allegations that any institution voted Unocal stock held in pension fund portfolios based on pressure it received from corporate clients, but the incident does illustrate the pressures on money managers in a proxy fight.

As a number of the Subcommittee's witnesses pointed out, this subject is not one that most money managers are eager or willing to discuss for the public record. Mr. Heard noted that, absent the existence of "some whistleblowers willing to step forward and blow the whistle," it is very difficult to prove that such violations are occurring.[129] Despite the absence of individuals willing to speak for the public record, the Subcommittee nonetheless finds the anecdotal evidence indicating that fiduciary violations are occurring to be persuasive.

Based on its hearings, interviews, and research, the Subcommittee believes that some ERISA fiduciaries are not complying with the mandate of the statute to act solely in the interest of plan participants and beneficiaries when voting the stock held in pension fund portfolios. The evidence strongly indicates that voting decisions are being made by some fiduciaries in pursuit of their own economic interests, typically in response to outside pressure or motivated by a desire not to offend existing or potential clients. Given the understandable reluctance of ERISA fiduciaries to acknowledge conflicts of interest and pressure, the Subcommittee agrees with the conclusion reached by Mr. Heard who testified that it is logical to assume that such abuses are "going on on a much wider scale than we know about." [130]

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[127] Supra note 112, pp. 145–147.

[128] Laurie P. Cohen and Frederick Rose, "Unocal Is Seen Gaining on Mesa in Proxy Fight, *The Wall Street Journal*, May 10, 1985, Hearing Record at 532.

[129] Hearing record at 197.

D. PENSION FUNDS AND CONTESTS FOR CORPORATE CONTROL

The use of pension fund assets in contests for corporate control also poses serious conflict-of-interest problems for pension fund sponsors, trustees, and investment managers. The Subcommittee focused on whether or not the fiduciary principles established by ERISA and their enforcement by the Department of Labor are adequate to protect the interests of plan participants and beneficiaries and to guard against the abuse of pension fund assets.

In the context of corporate takeovers, conflicts of interest may arise because officers of a corporation often serve as trustees of the corporation's pension plan. As corporate officers, they have a duty to the corporation and its shareholders; as pension trustees, however, they have a fiduciary duty to the pension plan and its beneficiaries. The interests of the two groups do not always coincide.

In some cases, these corporate trustees may be tempted to use plan assets to either acquire stock in a company which is the takeover target of the plan sponsor or to defend against unfriendly takeover attempts. In his written testimony, Michael Gordon clearly identified the problem which arises in both of these situations:

> [U]nless the fiduciaries of the plan with investment responsibility are totally independent of the plan sponsor, the underlying problem is almost always the same regardless of whether the situation involves the duty of a fiduciary to tender shares held by the plan in the plan sponsor who is the target of a hostile takeover bid, or whether the situation involves actions taken by the trustee to invest in stock of the plan sponsor so as to thwart a takeover bid or to invest in stock of a company which is the takeover target of the plan sponsor. In each of these instances, a pure investment decision on behalf of participants and beneficiaries cannot be made objectively because the fiduciary making the decision is also an agent of the vitally interested plan sponsor.[131]

Investment managers may also face conflicts of interest in the context of corporate takeover battles. In its report to the Department of Labor, the IRRC illustrated this problem with the following example:

> A bank serving as trustee for an employee savings plan holding a substantial amount of stock in a corporation that becomes the target of a hostile takeover attempt may also have a close commercial banking relationship with

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[130] Hearing record at 198.

[131] Hearing record at 123.

> the target company. The bank's fiduciary obligation to savings plan participants and its wish to maintain its banking relationship with the target company's management may create a potential conflict of interest.[132]

The IRRC noted that the growth of employee stock ownership plans (ESOPs) and other employee ownership programs is "likely to mean that plan sponsors, trustees and financial intermediaries serving as trustees for such plans will be forced to confront such situations more frequently in the future.[133]

In commenting on these conflict-of-interest problems, Mr. Clayton best expressed the views of the witnesses who addressed this question when he stated that "retirement funds were not intended to be tools of entrenched management to protect themselves or allow management to further corporate interests. Although ERISA recognizes that fiduciaries may have two hats, that of a corporate manager and trustee, when acting in a fiduciary capacity such a manager must act in full compliance with fiduciary duties under the law." [134]

A number of the Subcommittee's witnesses commended the Department of Labor for the job it has done in this area. "In addressing the abusive use of plan assets," the Department "has probably done the best job overall in terms of ERISA enforcement," according to Mr. Lanoff. He added that the "Department has also not hesitated to get involved in situations before they even develop into abuses." [135]

In his testimony, the DoL Solicitor, Frank Lilly, noted the "Considerable time and energy" which the Department of Labor has devoted to cases resulting from "the charged atmosphere on Wall Street surrounding the escalating number of corporate takeover attempts and mergers."[136] The Department of Labor has initiated a number of enforcement actions to protect plan assets. For example, the Department has issued several "enforcement letters" warning pension plan trustees against actions that would violate the fiduciary requirements of ERISA. In two situations involving leveraged buyouts of large publicly held corporations, Raymond International, Inc. and Blue Bell, Inc., the DoL issued enforcement letters which set forth the Department's views on the duties of the plan fiduciaries. The Department believes that its actions resulted in significant improvements in the plans' investments.[137]

Through litigation, the Department also has successfully established the principle that pension plan assets cannot be used to promote takeover attempts by the plan's sponsoring company. In *Leigh* v. *Engle,* 727 F.2d 113 (1984), in which the Labor Department intervened on behalf of the plan's beneficiaries, the court ruled that plan administrators violated ERISA by using plan assets to purchase stocks of companies that were takeover targets of the defendants. Applying the prohibited transaction standards of ERISA which forbid the use of plan assets for the benefit of a party-in-interest on to further the fiduciary's own interest, the court held that using plan assets to further the takeover aspirations of a party-in-interest to the plan was unlawful, at least without independent trustees to consider this use of the fund's assets.

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[132] Supra note 76, hearing record at 696.

[133] Id.

[134] Hearing record at 18.

[135] Hearing record at 27.

[136] Hearing record at 133.

[137] Hearing record at 165.

The courts also have concurred with the Department of Labor's view that pension assets may not be used to protect a company and its management against a change in corporate control. The leading case, *Donovan* v. *Bierwirth,* 538 F. Supp. 463 (1981), involved the Grumman Corporation's use of its pension plan's assets to defend against a hostile takeover attempt by LTV Corporation. While rejecting the Labor Department's argument that the trustees engaged in a *per se* prohibited transaction, the court held that the trustees' decision to expend plan assets to purchase stock of the sponsor corporation was "motivated solely by their all-consuming desire to defeat the tender offer" and violated the prudence rule.[138]

Mr. Clayton praised the Department for defending the interests of a plan's workers and beneficiaries in cases where management trustees attempt to use plan assets to influence the outcome of a contest for control of the corporation. Explaining the trustees' obligations, Mr. Clayton testified that:

> [W]hen fiduciaries are involved in a corporate takeover situation, the decision to tender or acquire shares must be made solely in the interest of plan participants and beneficiaries. Where management trustees are in control of the plan which is involved in the corporate takeover fight, an irreconcilable conflict of interest exists. Management trustees should either resign, allow independent trustees to make the decisions, or should obtain independent objective advice and act upon that advice.[139]

While commending the Department for the steps it has taken in enforcing fiduciary standards in this area, Mr. Clayton noted that corporate takeover situations "highlight some of the limited enforcement capabilities of the Department of Labor." [140] He testified that because the parties involved may be well financed, enforcement efforts require a major commitment of the Department's limited resources. He also cited the typically short time constraints involved, which he said "leave the Department little time to analyze the issues and take appropriate steps before the harm is done." [141]

Despite these problems, Mr. Clayton stated that "where the Department has chosen to intervene, they have been very effective." [142] This view was echoed by Ian Lanoff who commented that the takeover area is "an example of at least . . . one area where the Labor Department has succeeded in using its resources in an appropriate way." [143]

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[138] *Donovan* v. *Bierwirth,* 538 F. Supp. 463, 471 (1981), hearing record at 781.
[139] Hearing record at 17-18.
[140] Hearing record at 83.
[141] Id.
[142] Hearing record at 18.
[143] Hearing record at 27.

This view, however, was not shared by Michael Gordon who criticized the Department of Labor for failing to "develop a unified and coherent strategy which will clearly and unmistakably deter corporate plan sponsors from manipulating employee pension plans to their advantage." Mr. Gordon testified that the Department's method of attacking abuses of pension funds in corporate takeovers "provides too much leeway to self-serving corporate insiders, and leaves too many questions to be resolved after litigation is brought rather than before, when many of these abuses can be nipped in the bud." [144]

Referring to his earlier testimony on the conflicts of interest created when the plan fiduciary with investment authority is also an agent of the plan sponsor,[145] Mr. Gordon also identified a problem in the underlying law:

> At this juncture, the law does not clearly and unequivocally require investment decisions of this kind to be taken out of the hands of the compromised fiduciaries and given over to those who have no stake in the outcome. Nor does the law clearly and unequivocally require the potential transaction to be brought to DOL as if it were a prohibited transaction requiring an exemption. There are a number of technical and, perhaps, practical reasons for these deficiencies but they are not of overwhelming significance. The fact remains that litigation or the threat of litigation over whether the compromised fiduciary failed in putting the interests of participants ahead of the plan sponsor's is the sole weapon now available to DOL.[146]

In his testimony, Mr. Lanoff expressed similar concerns regarding the absence of a requirement for independent fiduciaries. Citing the *Bierwirth* case, he noted that the Department of Labor had attempted to persuade the court that "it is a per se prohibited transaction in a situation where trustees of a plan who are also corporate officers [and] who are threatened by a takeover make the decision one way or another with respect to the use of plan assets to thwart or further the takeover." [147] In *Bierwirth,* the court rejected the Department's per se argument but did find that the trustees had violated their fiduciary duties under the prudence standard. Stating that it would have been very beneficial if the court had adopted the Department of Labor's theory "that the trustees of plans in such a situation cannot become involved," Mr. Lanoff testified that "these kinds of decisions have to be shifted to outside independent fiduciaries when a takeover occurs because of the inherent conflict that these trustees face," since they are also "corporate officers whose jobs are at stake." [148]

In response to questioning from Senator Cohen regarding the need to amend ERISA to insulate plans during a takeover, Mr. Gordon also expressed regret at the court's rejection of the Department of Labor's argument in *Bierwirth* and noted that, as a result,

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[144] Hearing record at 109.
[145] Supra note 127, hearing record at 123.
[146] Hearing record at 123-124.
[147] Hearing record at 27-28.
[148] Hearing record at 28.

"it means . . . that the Labor Department now always has to litigate the question or threaten litigation on the question of whether the corporate officers who are also the trustees are really acting in the interest of the participants and beneficiaries." [149] Arguing that these conventional litigation tactics available to the Department are inadequate to stem the tide "of real and potential abuse" in the corporate takeover area, Mr. Gordon stated that "we should not be misled into thinking that they are because DOL appears successful in using them in particular instances." [150] Therefore, Mr. Gordon testified, ERISA should be amended "so that a *cordon sanitaire* is thrown up around employee pension plans during takeover struggles. By statute, decisions affecting the use of pension fund assets that will benefit plan sponsors in their takeover battles should be taken out of the hands of these compromised fiduciaries." [151] He went on to say that this matter is "of the highest priority because it greatly affects the integrity and effectiveness of private pension plan administration." [152]

The Subcommittee shares the concerns expressed during the hearing regarding the need to adequately guard against the misuse of plan assets in the context of corporate takeovers. Because of the inherent conflicts of interest and the serious potential for abuse, the Subcommittee finds that it is necessary to insulate plans so that decisions involving the use of plan assets are made solely on behalf of plan participants and beneficiaries and independently of the interests or goals of plan sponsors. In the Subcommittee's judgment, ERISA may need to be amended to strengthen and clarify the law in this area. The Subcommittee joins those who have commended the Department of Labor for the steps it has taken and believes high priority should continue to be given to efforts to guard against the abuse of pension fund assets.

E. TENDER OFFERS

Pension funds and other institutional investors have come to dominate the ownership of stock in U.S. corporations. In the wake of the recent epidemic in corporate takeover attempts, this dominance has given rise to some criticism of the role played by pension funds in the context of hostile takeovers and strong disagreement on what ERISA requires of fiduciaries in responding to tender offers. In light of the divergence of views on the question of fiduciary obligations in accepting or rejecting tender offers, the Subcommittee felt it was necessary to explore this issue as part of its examination of the application of the fiduciary duties set forth in ERISA to the corporate governance area.

All of the Subcommittee's witnesses agreed that it is the fiduciaries' duty to act prudently and in the exclusive interest of the plan's participants and beneficiaries but, as Mr. Gordon noted, "what that implies exactly in tender offer situations is open to argument.[153] The Subcommittee received testimony providing a range of views on this question.

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[149] Hearing record at 97.

[150] Hearing record at 124.

[151] Hearing record at 125.

[152] Id.

[153] Hearing record at 121.

On one side of this issue is the view that fiduciaries have a legal duty to accept whatever provides the pension plan's participants and beneficiaries with the highest immediate return. In an editorial-page article which appeared in *The Wall Street Journal,* Peter F. Drucker argued that, as fiduciaries, pension fund managers are required to accept the highest bid for the stock they hold, regardless of whether they believe a takeover to be in the best interest of either the acquiring or target company, and that they are "forbidden as fiduciaries even to consider the interest of the enterprise." [154]

Precluded from exercising the traditional "owners" right to weigh the short-term prospects of accepting the tender offer versus the long-term prospects of the company under existing management, the fiduciary's only concern is the immediate gain to the beneficiaries. Because pension fund managers and other institutional investors must tender their shares to any bidder offering even a small premium over the market price, Mr. Drucker and others argue that the shift in voting power from traditional individual owners to fiduciaries of pension funds and other institutional owners has facilitated hostile tender offers and is the cause of the recent wave of unfriendly takeovers.

In turn, the takeover epidemic and the takeover fear gripping corporate America, it is asserted, is the "main cause of the decline in America's competitive strength in the world economy" and has contributed to the "obsession with the short term and the slighting of tomorrow in research, product development, market development and marketing, and in quality and service." [155]

The opposing view on what is required of fiduciaries was articulated by Robert Monks when, as administrator of OPWBP, he responded to Mr. Drucker's article in a letter to the editor which was also published in *The Wall Street Journal.* Stating that ERISA "does not require pension fund fiduciaries to act in such a simplistic manner," Mr. Monks asserted that a fiduciary, in evaluating such a bid, must act prudently and solely in the interests of plan participants and beneficiaries. This requires, he argued, "a careful evaluation of long-term prospects of the company under existing management as against the short-term prospects presented by the takeover offer and by the ability to invest the proceeds elsewhere." [156]

In support of his position, Mr. Monks cited the fact that at least one-third of the stock of publicly owned corporations and fifty per cent of the big publicly owned corporations are owned by institutional investors. Institutional investors "have to act more like long-term owners and less like mere traders in the market, since their size relative to the market will make it increasingly difficult to move into and out of positions," Mr. Monks argued.[157]

Mr. Lanoff, in agreeing with this assessment, testified that the Department of Labor's failure to provide guidance in this area has perhaps resulted in some confusion. He noted that some individuals have blamed pension plans for "always taking the short-term view in takeover situations, and always tendering" and that they have construed this action as being required by ERISA. Mr. Lanoff disputed this interpretation of ERISA's fiduciary requirements. "if any institution in this country is capable of taking a long-term view," Mr. Lanoff stated, "it is the pension fund fiduciaries." [158]

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[154] Peter F. Drucker, "Taming the Corporate Takeover," *The Wall Street Journal,* October 30, 1984, Hearing Record, pp. 533–534, at 534.

[155] Id. at 533.

[156] Robert A.G. Monks, "Pension Funds as Stockholders," *The Wall Street Journal,* November 23, 1984, Hearing Record at 535.

[157] Id.

At the hearing, Senator Cohen asked Mr. Lanoff if he agreed with Mr. Monks in "rejecting the Peter Drucker view that . . . you have an obligation as a fiduciary to sell at the best price." Mr. Lanoff responded that sometimes, and perhaps in most situations, a fiduciary will want to tender to the highest bidder but that he does not believe there is a *per se* requirement under ERISA to do so. Fiduciaries, he pointed out, can "weigh the pros and cons" of the tender offer and are "free to tender or not to tender" under the prudence rule.[159]

Other witnesses, however, agreed with the view that a pension fiduciary has an obligation to accept the highest bid, although most witnesses qualified their support saying that it would depend on the individual circumstances of a particular tender offer.

The strongest endorsement of the view that a fiduciary has an obligation to pursue the highest immediate return, came from Dean LeBaron who had the following exchange with the chairman:

> Senator COHEN. In your prepared statement, you discuss the maximization of profit motive. Do you support the view that the ERISA fiduciaries, in the context of any corporate take-over battle, have a legal duty to accept the highest bid for the stock held by the pension funds?
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> Mr. LEBARON. [Yes] Whatever it may be. I also suggested . . . that if we polled the beneficiaries [and asked them] which would they rather have us do—give a quiz to the motives of potential purchasers or to just go and take the highest price, thereby increasing the likelihood that they'll get the benefits that they've been promised—I'm assuming . . . that they will tell us to take the highest value.[160]

In his written testimony, Mr. LeBaron expanded on this point:

> A takeover is little different than any other offer to purchase. Shares are continuously offered in the market to the highest bidder so that the price . . . always reflects the highest and presumably best use of the asset. We do not challenge the motives or competence of prospective purchasers of securities we sell in day-to-day transactions through our normal stock exchange process, nor do we necessarily feel that our clients want us to second-guess the outcomes in specific takeover situations.[161]

Mr. Gordon expressed similar sentiments that, ordinarily, fiduciaries should vote in support of a tender offer if it would maximize the assets of the fund and that a fiduciary "should not have to speculate on the fate of the target company." It is sufficient, he stated, "if the fiduciary knows that at the time the tender offer is made that it is in the interests of the plan as investor to accept it."[162]

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[158] Hearing record at 26.

[159] Id.

[160] Hearing record at 169.

[161] Hearing record at 173.

Mr. Gordon cautioned, however, that there are exceptions to this general rule. He warned that:

> [S]uch an approach ignores the reality of some hostile takeovers which are stimulated by corporate raiders whose previous record indicates that their sole purpose is to strip a target company of all its valuable assets after the takeover is completed and leave it a corporate shell with little or no business future. To the extent such tactics become widespread and successful, they tend to reduce the availability to pension funds and other institutional investors of diverse and sound long-term investments. I believe that pension fund fiduciaries do not breach their ERISA obligations if, because of the prior track record of those making the tender, they decline to vote in its favor.[163]

George Cowles, Senior Vice President of Bankers Trust Company, testified that a fiduciary's obligation is to maximize the rate of return for a plan's participants and beneficiaries. He went on to state that while this is the primary objective, "in a tender offer situation, if you're talking cash, that's one thing. If you're talking paper of questionable value, then you've got an investment research job to determine whether that, in fact, is more valuable than continuing to hold on to the security."[164]

Based on the testimony, the Subcommittee believes that a pension fiduciary does *not* have a legal obligation to invariably accept the highest bid, regardless of the individual circumstances of a tender offer. The Subcommittee shares the concerns expressed by Mr. Lanoff regarding the confusion surrounding the fiduciary obligation in responding to tender offers and believe that an effort should be made to clarify what ERISA requires of fiduciaries in this area. Given the importance of pension funds as long-term investors and their dominance in the stock market, the answer to this question has important implications for both pension funds and corporate America.

F. Recommendations

Due to the growth of pension fund assets and the emergence of pension funds as major investors in the stock of publicly traded corporations, private pension funds have become increasingly large and powerful influences in the securities market. As partial owners of the corporations in which they hold voting shares of stock, pension funds have an important role to play in issues of corporate governance. Based on its investigation and hearings, the Subcommittee makes the following recommendations:

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[162] Hearing record at 121.
[163] Hearing record at 122.
[164] Hearing record at 183.

1. CLARIFICATION OF THE FIDUCIARY DUTY

There are indications that ERISA's fiduciary standards have heightened sensitivity to the role that pension funds play in the corporate governance process and that many ERISA fiduciaries are engaging in a thoughtful analysis of these issues. Nevertheless, there is also evidence that some fiduciaries are not fulfilling their obligations to plan participants and beneficiaries in this area. The Subcommittee believes that fiduciaries have an obligation to engage in a careful evaluation of those corporate governance issues which can affect the rights of shareholders and the value of their investments and to vote the stock according to the best interests of plan participants and beneficiaries. To the extent that fiduciaries are failing to engage in this process, the Subcommittee believes they are in violation of the statute's standards of fiduciary conduct. As was noted during the hearings, to some extent these obligations may be neglected out of ignorance.

While these fiduciary obligations have been the subject of discussion within the pension community and by officials of the OPWBP, little formal guidance has been provided by the Department of Labor. The Subcommittee believes the Department should take immediate steps to formulate and issue a policy statement specifying what it believes to be the responsibilities of fiduciaries in the corporate governance area.

Any policy statement issued by the Department should specifically address the obligations of fiduciaries in voting stock held in pension fund portfolios. In addition, the Subcommittee believes that the Department, in preparing such a statement, should include a discussion of the fiduciary duty in voting on antitakeover charter amendments. While recognizing that not all antitakeover proposals are intended to simply protect management, the Subcommittee believes fiduciaries generally have an obligation to oppose such measures when they diminish the rights of shareholders or the value of their investments.

The Subcommittee found considerable confusion about a fiduciary's obligations in responding to tender offers. As part of a broader policy statement on corporate governance, the Department of Labor should take steps to clarify what ERISA requires of fiduciaries in this area.

In addition, the Subcommittee believes the Department must improve its efforts to work with the private sector to promote understanding of fiduciary obligations. Issuing a policy statement would give notice to pension fiduciaries that the Department of Labor believes careful attention must be given to corporate governance matters. It would also provide needed guidance to plan sponsors, trustees, and investment managers and, by doing so, would promote compliance with ERISA's fiduciary standards.

2. DISCLOSURE OF VOTES AND VOTING POLICIES

Efforts by the Department of Labor to clarify the fiduciary obligations in the corporate governance area would heighten fiduciaries' awareness and understanding of their obligation to act solely in the interests of plan participants and beneficiaries. As a consequence, fiduciaries would be less likely either through ignorance or insensitivity to cast votes which are contrary to the interests of the plan.

The Subcommittee is concerned, however, that greater understanding alone will not alleviate the conflicts of interest which are resulting in voting decisions by some fiduciaries in pursuit of their own economic interests. The Subcommittee believes that the Department of Labor should encourage plan sponsors and financial intermediaries to establish voting policies and procedures designed to ensure that potential conflicts of interest are resolved in favor of plan participants and beneficiaries. Cognizant to the difficulties facing the Department in uncovering abuses and in enforcing fiduciary obligations in the exercise of voting rights, the Subcommittee recommends that the Department consider requiring public disclosure of voting policies and procedures, as well as the actual votes cast by fiduciaries. Such disclosure was endorsed by a number of the Subcommittee's witnesses, including the three former administrators of the OPWBP.

In the Subcommittee's judgment, disclosure would go a long way toward eliminating abuses. Knowing that voting decisions can be subject to outside scrutiny, fiduciaries would be encouraged to engage in a more careful evaluation of corporate governance issues. Disclosure would also facilitate the Department of Labor's enforcement efforts by providing the Department and other interested parties with much needed information.

Public disclosure has been used effectively to encourage compliance with numerous other federal statutes and is already a fundamental aspect of ERISA's regulatory scheme. Expanding disclosure to encompass voting questions would be an effective tool in encouraging compliance with the statute's standards of fiduciary conduct in the corporate governance area.

3. RETENTION OF VOTING RESPONSIBILITY BY PLAN SPONSORS

The Subcommittee's hearings raised questions regarding the division of decision-making authority between plan sponsors and their outside managers on corporate governance issues and the common practice of delegating voting responsibility to outside managers.

A number of individuals, including some of the Subcommittee's witnesses, have suggested that voting responsibility should be retained by plan sponsors. In the Subcommittee's opinion, this proposal deserves the serious attention of plan sponsors, as well as the DoL. Further study is required in order to answer central questions, such as whether or not plan sponsors are in a better position to exercise voting responsibilities and to resolve conflict-of-interest problems. The Subcommittee urges the Department of Labor to encourage further discussion of this proposal within the pension community and to initiate and complete its own review as soon as possible.

4. SURVEY OF CORPORATE GOVERNANCE PRACTICES

As previously noted, there is very little information available on the policies and practices of pension funds in regard to corporate governance matters. To remedy this situation and to facilitate a study of voting responsibility, the Department should conduct a survey of ERISA fiduciaries, including plan sponsors, trustees, and investment managers, to obtain this information.

5. THE USE OF INDEPENDENT FIDUCIARIES

The use of pension fund assets by plan sponsors to protect management or to further corporate interests in the context of hostile takeovers poses a serious threat to the integrity of private pension plans. When corporate officers also serve as pension trustees, conflicts of interest may arise, particularly when the plan sponsor is either the target of or the bidder in a hostile takeover attempt. The Subcommittee believes it is essential to insulate plans so that decisions involving plan assets are made solely on behalf of plan participants and beneficiaries and independently of the interests or goals of plan sponsors.

To this end, the Subcommittee recommends that when fiduciaries face conflicts of interest because of their relationship with plan sponsors, the investment and voting decisions affecting pension assets should be placed in the hands of independent fiduciaries. The Subcommittee will work with the Department of Labor to develop legislation to strengthen ERISA in this area.

6. INVESTIGATION OF CONFLICTS OF INTERESTS

The evidence that some ERISA fiduciaries are not complying with the mandate of the statute to act solely in the interests of plan participants and beneficiaries when voting or tendering the stock held in pension fund portfolios is deeply disturbing. The Subcommittee believes that further investigation of these allegations is warranted and is, therefore, referring this matter and the documentation obtained by the Subcommittee to the Senate Governmental Affairs Permanent Subcommittee on Investigations (PSI). The Subcommittee recommends that PSI conduct an in-depth investigation to determine the truth of the allegations and to what extent these abuses are occurring.

VI. CONCLUSION

During the past year, the Subcommittee has reviewed the Department of Labor's enforcement of the provisions of ERISA governing private pension plans, with particular attention to the fiduciary duty established by the law.

The Subcommittee's investigation indicates that the Department is overwhelmed by its responsibilities under ERISA. Inadequate resources, conflicting priorities, and rapid turnover in the leadership roles have hampered the ability of the Labor Department to enforce this complex law. The Department's struggle to cope with its traditional enforcement activities raises serious questions about its ability to protect the rights of the workers and retirees counting on pension funds for their retirement income. At a time when ERISA fiduciaries have become major players in high stakes mergers and acquisitions, the Department faces even more challenging problems in interpreting and enforcing the law.

The problems that the Department has encountered are not totally of its own making. Congress has contributed to the enforcement quagmire by splitting jurisdiction for ERISA among three separate agencies, by sending conflicting signals on what should be the DoL's enforcement priorities, and by paying scant attention to enforcement of the law once it was passed. By holding these oversight hearings, the Subcommittee hopes to have alleviated the latter problem.

The authors of ERISA did not anticipate what a significant impact pension funds would have on the stock market. As a consequence, the Department of Labor has had to chart its own path in the thorny forest of corporate governance issues, with little or no guidance from the legislative history of the Act. In some areas, such as its litigation to prevent the abuse of pension assets in contests for corporate control, the Department has vigorously defended the interests of plan participants and beneficiaries. On other issues, however, the Department has failed to act and, in fact, has yet to respond to specific corporate governance recommendations in studies for which it contracted.

Of course, even with strong leadership and all the resources it needs, the Department cannot be expected to police every transaction of every plan. To a large extent, the Department must depend on pension plan fiduciaries adhering to the standards set forth in the law—that is, to make decisions solely in the interests of the plan's workers and beneficiaries—without the federal government checking on each action.

More than 50 years ago, Justice Cardozo established the standard for fiduciary behavior when he wrote:

> Many forms of conduct permissible in a workaday world . . . are forbidden for those bound by fiduciary ties. A

> trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctillo of an honor the most sensitive, is then the standard of behavior.[165]

It is perhaps difficult for ERISA fiduciaries to raise above the "morals of the marketplace" when pension investments play such a dominant role in the marketplace. But the obligations of those who handle ERISA funds are clear. As the court held in *Donovan* v. *Bierwirth*:

> [W]hen a fiduciary has dual loyalties, his independent investigation into the basis for an investment decision . . . must be both intensive and scrupulous and must be discharged with the greatest degree of care that could be expected under all the circumstances by reasonable beneficiaries and participants of the plan. Were the rule less stringent, we could not be sure that the Cardozian time-honored standard for fiduciary behavior would remain uncompromised.[166]

Plan sponsors, in addition to the Department of Labor, need to be more active to ensure the integrity of pension funds. In some cases, achieving this goal may require plan sponsors to retain voting responsibility for the shares in the plan's portfolio. Plan sponsors who delegate such decisions to outside managers should monitor closely how voting decisions are made to ensure that they are not tainted by conflicts of interest.

Investment managers, too, need to play a greater role in the debate on the fiduciary duty under ERISA. While investment managers and other institutional investors were among the first to question the effect of antitakeover measures on the value of the shareholders' investment, it is equally clear that money managers, as a group, have been reluctant to confront publicly the problem of conflicts of interest.

To ensure the effective implementation of ERISA, all of the players in the system must be involved in effecting solutions to the many problems discussed in this report. The Subcommittee believes that implementation of our recommendations, plus more debate on issues of corporate governance, would help to fulfill the promise of ERISA.

Finally, the Subcommittee wishes to thank all those who contributed to this investigation. Department of Labor officials cooperated fully with the Subcommittee; the three former administrators provided invaluable insight into the problems of the Department; organizations such as the Investor Responsibility Research Center, the Employee Benefit Research Institute, and the Association of Private Pension and Welfare Plans were generous in sharing their research, and individual investment managers and plan sponsors contributed greatly to the Subcommittee's understanding of these complex issues.

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[165] *Meinhard* v. *Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928).

[166] *Donovan* v. *Bierwirth*, 538 F. Supp. 463, 470 (1981), Hearing Record at 780.

Private Pension Plan Assets, 1975-85 ($ billions)

Source:
Data for 1975-81 based on Form 5500 annual financial reports and on Pension Facts published by the American Council of Life Insurance. Data for years 1983-85 are projected estimates.

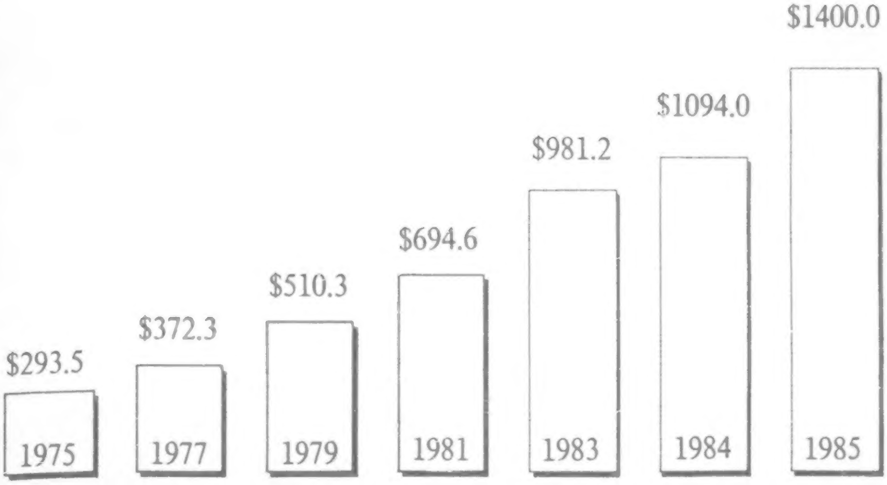

Chart: Senate Republican Conference